(17)

No. 95-1402-CFX Title: Commissioner of Internal Revenue, Petitioner
v.
Estate of Otis C. Hubert, Deceased, et al.

Docketed: March 1, 1996 Court: United States Court of Appeals for the Eleventh Circuit

Entry	Date	Proceedings and Orders
	Mar 1 1996	Petition for writ of certiorari filed. (Response due March 31, 1996)
	Apr 1 1996	Brief of respondent Estate of Otis C. Hubert in opposition filed.
	Apr 10 1996	DISTRIBUTED. April 26, 1996
	Apr 11 1996	Reply brief of petitioner filed.
	Apr 29 1996	Petition GRANTED. SET FOR ARGUMENT November 12, 1996. **********
	Jun 13 1996	Joint appendix filed.
	Jun 13 1996	Brief of petitioner Commissioner of Internal Revenue filed.
	Jun 27 1996	Order extending time to file brief of respondent on the merits until August 6, 1996.
	Aug 5 1996	Motion of American College of Trust and Estate Counsel for leave to file a brief as amicus curiae filed.
	Aug 6 1996	Brief amici curiae of American Council on Education, et al. filed.
	Aug 6 1996	Brief of respondent Estate of Otis C. Hubert filed.
	Aug 6 1996	Brief amicus curiae of Tax Section of the Florida Bar filed.
	Aug 6 1996	Brief amici curiae of Baptist Foundation of Texas and Terry L. Simmons filed.
	Sep 9 1996	CIRCULATED.
	Sep 11 1996	Reply brief of petitioner Commissioner of Internal Revenue filed.
	Sep 12 1996	Record filed.
	Sep 20 1996	Motion of American College of Trust and Estate Counsel for leave to file a brief as amicus curiae GRANTED.
	Nov 12 1996	ARGUED.

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95-1402

Supreme Court, U.S.
FILED
MAR 1 1996

No.

In the Supreme Court of the United States

OCTOBER TERM, 1995

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA) N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, in calculating the taxable estate for the purpose of the federal estate tax, the marital and charitable deductions allowed by Sections 2055 and 2056 of the Internal Revenue Code, 26 U.S.C. 2055, 2056, are reduced by the expenses of administration of the estate.

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In the Supreme Court of the United States

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No.

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v.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA) N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Eleventh Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-23a) is reported at 63 F.3d 1083. The opinion of the Tax Court (App., *infra*, 26a-79a) is reported at 101 T.C. 314.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1995. The petition for rehearing with

suggestion for rehearing en banc was denied on December 5, 1995 (App., *infra*, 24a-25a). The jurisdiction of the Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATION INVOLVED

1. 26 U.S.C. 212 provides, in relevant part:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

2. 26 U.S.C. 641(b) provides:

> The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

3. 26 U.S.C. 642(g) provides:

> Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the

> Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect to decedents).

4. 26 U.S.C. 2053(a) provides:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—
>
> (1) for funeral expenses,
> (2) for administration expenses,
> (3) for claims against the estate, and
> (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,
>
> as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

5. 26 U.S.C. 2055 provides, in relevant part:

> (a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers—

* * * * *

(2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes * * *.

* * * * *

(d) The amount of the deduction under this section for any transfer shall not exceed the value of the transferred property required to be included in the gross estate.

* * * * *

6. 26 U.S.C. 2056 provides, in relevant part:

(a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

* * * * *

(b)(4) In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—

(A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax,

has on the net value to the surviving spouse of such interest; and

(B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

7. 26 C.F.R. 20.2056(b)-4(a) provides, in relevant part:

The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of the date of the decedent's death. * * *. The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the adminstration of the estate.

STATEMENT

This case concerns the estate tax liability of the estate of Otis C. Hubert, formerly a resident of Georgia. Mr. Hubert died in 1986, leaving an estate greater than $30,000,000 (App., *infra*, 3a).

1. An estate is a taxable entity. It is subject to both the federal estate tax and the federal income tax. The estate tax is imposed on the taxable estate, which is the gross value of the decedent's estate at the time of death less deductions authorized by statute. 26 U.S.C. 2001, 2051. The income tax is imposed annually on the net income received by the estate from administration of the assets of the estate during the period prior to distribution of those assets to the heirs and other claimants. 26 U.S.C. 641(b).

This case concerns the correct application of the "marital" and "charitable" deductions under the federal estate tax. These deductions (along with others) are subtracted from the gross value of the dededent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. Under Section 2056(a) of the Code, the "marital deduction" is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)). Similarly, the "charitable deduction" is the amount of "the value of the * * * property" that is transferred to a charitable organization (26 U.S.C. 2055(d)). Thus, the "value" of the property in Mr. Hubert's estate "which passes" to his surviving spouse or to a charity passes free of the estate tax under Sections 2055 and 2056.

2. Mr. Hubert's last will was executed in 1982 and was thereafter amended by two codicils. Following his death, the provisions of the will and codicils were

challenged by various interested parties. The resulting litigation was settled under an agreement that was approved by the Georgia probate court in 1990 (App., *infra*, 29a). The parties to that litigation have stipulated that the distribution of the estate is to be controlled by this settlement agreement, rather than by the decedent's will (*id.* at 29a-30a).

Under the terms of the settlement agreement, the residuary assets of the estate were allocated between a marital and a charitable share (App., *infra*, 30a). The marital share was vested in two trusts: One provides for the payment of income for life to the decedent's wife, with a general power of appointment to her in the remainder; the other provides for the payment of income for life to the decedent's wife, with the remainder to charity.[1] The charitable share of the residuary assets was distributed directly to specified charitable institutions. Under the terms of the settlement agreement, the marital and charitable shares were $13,353,572 and $12,870,864, respectively (*id.* at 74a). The administration expenses of the

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[1] The first of these two trusts is a "GPA" trust; the second is a "QTIP" trust. A trust that qualifies for the marital deduction under Section 2056(b)(5) of the Code by giving the surviving spouse both a lifetime income interest and a general power of appointment over the corpus of the trust is referred to as a "GPA" (general power of appointment) marital trust. If the spouse has only a lifetime income interest in the trust, but the trust otherwise is a "qualified terminable interest property" (QTIP) trust by virtue of an irrevocable election, it also qualifies for the marital deduction. See 26 U.S.C. 2056(b)(7)(A)(i) and 2044. The marital deduction extends to both types of trust because the corpus of both trusts is includable in the estate of the surviving spouse.

estate were to be allocated between the marital and charitable shares (*id.* at 30a).

3. The litigation challenging the will delayed the final administration of the estate. During the years prior to distribution of the estate assets, the estate earned significant amounts of income—between 1986 and 1991, the estate's income exceeded $4,500,000. During this same period, the estate also incurred significant adminstration expenses, including attorney's fees, that exceeded a total of $2,000,000 (App., *infra*, 3a).

Under Georgia probate law, an executor may charge payments of administrative expenses either against the income of the estate or against its principal, if the will so provides. Ga. Code Ann. § 53-15-3 (Mitchie 1982). In this case, the decedent's will authorized the executors "to charge any expenses against income or principal or apportion the same" (App., *infra*, 37a). Acting pursuant to this authority, the executors charged $506,989 of the administration expenses against the principal of the estate in the state probate proceedings. As permitted by 26 U.S.C. 2053(a)(2), those charges were deducted from the gross estate in calculating the value of the taxable estate for purposes of the federal estate tax (*id.* at 3a). All other administration expenses were charged by the executors against the income earned by the estate. As permitted by 26 U.S.C. 212, those charges were deducted from the income earned by the estate during the period of administration for purposes of the federal income tax, as expenses paid for the production of income (App., *infra*, 37a-39a).

Section 642(g) of the Internal Revenue Code authorizes executors to elect to deduct administration expenses either on the estate tax return or on

the estate's income tax returns. 26 U.S.C. 642(g). When administrative expenses are paid from the corpus of the residuary estate left to the surviving spouse and are deducted on the estate tax return (under 26 U.S.C. 2053(a)(2)), this reduces directly the amount of property that passes to the surviving spouse, and therefore reduces directly the marital deduction under 26 U.S.C. 2056(a). *Estate of Luehrmann* v. *Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961) ("Obviously, if the administration expenses are in fact paid out of the corpus of the estate, the residue of the estate will be diminished by such payment."). See also *Estate of Roney* v. *Commissioner*, 33 T.C. 801, 804 (1960), aff'd per curiam, 294 F.2d 774 (5th Cir. 1961). The executors in this case accordingly reduced the amount of the marital and charitable deductions claimed on the estate tax return by the amount of the administration expenses charged against the principal of the estate. The executors did not, however, make such reductions in the marital and charitable deductions for the administrative expenses charged against the income of the estate and deducted in the calculation of the estate's income tax pursuant to Sections 212 and 642(g) (App., *infra*, 37a).

4. The Commissioner of Internal Revenue issued a notice of deficiency with respect to the estate taxes owed by the estate. The Commissioner took the position that the marital and charitable deductions of the estate had been overstated and must be reduced by the total administration expenses paid by the estate, whether the executors elect to charge those expenses against the principal or the income of the estate (App., *infra*, 30a, 37a).

a. Sections 2055 and 2056 of the Internal Revenue Code specify that the charitable and marital deductions may not exceed "the value of any interest in property which passes * * * from the decedent to" the charity or the surviving spouse (26 U.S.C. 2056(a); see 26 U.S.C. 2055(d)). The amount of these deductions are limited "to the value [at the time of death] of the property that is actually received" by the surviving spouse or charity (*Estate of Street* v. *Commissioner*, 974 F.2d 723, 726 (6th Cir. 1992)). See *Estate of Luehrmann* v. *Commissioner*, 287 F.2d at 13. Section 2056(b)(4) of the Code further specifies that, in determining the "value" of the property that passes to the surviving spouse, any obligation or encumbrance upon that property is to be taken into account. 26 U.S.C. 2056(b)(4).

If the income from the property that is to pass to the spouse or charity is burdened by the necessity of paying the obligations of the estate (whether for adminstration expenses or otherwise), the "value" of the property that "passes" to the spouse or charity is obviously less than what it would be if it passed unencumbered at the time of death. Under Sections 2055 and 2056, the "value" that passes to the spouse or charity of the assets that are burdened by the obligation to pay administration expenses is thus less than the full, unencumbered value of those assets, and the marital and charitable deductions must therefore be reduced accordingly. *Estate of Street* v. *Commissioner*, 974 F.2d at 726 (marital deduction); *Estate of Luehrmann* v. *Commissioner*, 287 F.2d at 13 (charitable deduction). Three courts of appeals have agreed with the Commissioner that, when (as in the present case) "the value of [the] interest in property which passes" (26 U.S.C. 2056(a)) to the surviving

spouse or charity is encumbered by the necessity of paying the administration expenses of the estate, the marital and charitable deductions are reduced by those expenses whether the estate elects to charge them directly against its corpus or, instead, against the income from the encumbered property. *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993); *Estate of Street* v. *Commissioner*, 974 F.2d 723 (6th Cir. 1992), rev'g in relevant part T.C. Memo. 1988-533; *Alston* v. *United States*, 349 F.2d 87 (5th Cir. 1965).[2]

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[2] For example, assume an estate with a gross value of $1,000,000 on the date of death, $100,000 of which is to pass to a specified heir, with the residuary interest to pass to the spouse. Assume that, as in the present case, the expenses of administration are to be charged against the residuary estate. Assume further that administration expenses of $50,000 are incurred and paid on the first anniversary of the decedent's death. In order to pay those administration expenses, the executor could set aside a portion of the residuary estate on the date of death and pay the expenses from that severed portion when the expenses come due. That would, of course, directly diminish the "value" of the residuary interest on the date of death. The "value" of the residuary interest on the date of death is thus not $900,000 but is $900,000 *less* the funds that, if set aside on that date, would pay the administration expenses as they come due. This same conclusion holds if, instead of segregating the "corpus" for that purpose, the executor thereafter takes part of the earnings of the corpus to pay the administration expenses. In either case, the present "value" at the date of death of the property that ultimately passes to the spouse is less than the unencumbered sum of $900,000 as of that date. Because the value of the residuary estate that passes to the spouse is encumbered by the obligation to pay administration expenses, the expenses incurred in meeting that obligation must be reduced from the (theoretical, unencumbered) value of the property in determining the proper

b. The reductions in the marital and charitable deductions thus asserted by the Commissioner resulted in a larger taxable estate and in a deficiency in the estate tax. The estate petitioned the Tax Court for a redetermination of the estate tax deficiency (App., *infra*, 26a).[3]

5. a. In a reviewed opinion with two dissents, the Tax Court sustained the estate's position (App., *infra*, 26a-79a). The court concluded that administration expenses that are charged, under state law, against estate income (rather than corpus) do not reduce the value of the property passing to the spouse and to the charity, and therefore do not reduce the marital and charitable deductions. In so holding, the court relied (*id.* at 43a) on its prior decision in *Estate of Street* v. *Commissioner*, which the Sixth Circuit reversed (974 F.2d 723 (1992)). The Tax Court reasoned that "administration expenses come into existence only after the death of the decedent and may relate to both income and corpus" (App., *infra*, at 42a). The court stated that, because "administration expenses logically can be charged to either income or corpus" (*ibid.*), the allocation of those expenses under state law determines whether they are deductions from the corpus of the estate or only from the income earned by that corpus. The court concluded that, since Georgia law permits administration expenses to be allocated to income, and since the expenses

value of the marital deduction. See 26 U.S.C. 2056(b)(4); *Estate of Street* v. *Commissioner*, 974 F.2d at 726.

[3] Unrelated issues concerning the calculation of the marital and charitable deductions (App., *infra*, 30a-37a) and the imputed interest earned on the assets of the estate (*id.* at 50a-52a) were also raised in the notice of defiency. The Tax Court's rulings on those issues were not challenged on appeal.

involved in this case were allocated to income by the executors, these expenses do not reduce the corpus of the marital and charitable interests and therefore have no effect on the proper value of the marital and charitable deductions (*id.* at 39a).

The Tax Court stated that the regulations adopted under Section 2056 did not alter its conclusion. Those regulations specify that (26 C.F.R. 20.2056(b)-4(a)):

> The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of the date of the decedent's death * * *. * * * In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of a property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

The Tax Court stated that this regulation is "merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse" (App., *infra*, 40a). The court held that the fact that the interest of the surviving spouse is burdened by the obligation to pay administration expenses is not "a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate" (*ibid.*).

The Tax Court recognized that, in *Estate of Street* v. *Commissioner*, 974 F.2d at 728, the Sixth Circuit held that administration expenses reduce the value of the property passing to the spouse, and therefore reduce the amount of the marital deduction, even when these expenses are charged to the income from the estate. The court further noted that the Federal Circuit had applied and followed *Estate of Street* in a parallel case involving the charitable deduction (App., *infra*, 46a, citing *Burke* v. *United States*, 994 F.2d at 1581). The Tax Court stated that it disagreed with the rea-soning of the Sixth Circuit and "decline[d] to follow its decision in *Estate of Street*" (App., *infra*, 46a).

b. Judge Halpern and Judge Beghe wrote separate dissenting opinions. Judge Halpern stated that the relevant inquiry should be whether the income of the estate would have been received by the surviving spouse or charitable beneficiary if that income had not been used to pay administration expenses (App., *infra*, 66a). If, as in this case, it would have been, "then it follows easily that, when such income is used for administration expenses, rather than [being] received by the surviving spouse or charitable beneficiary, the value of the interest passing from the decedent to the surviving spouse or charitable beneficiary is decreased," and the marital and charitable deductions must therefore be reduced (*ibid.*; see also note 3, *supra*). Judge Halpern stated (App., *infra*, 67a) that the Fifth Circuit was correct in concluding in *Alston* v. *United States*, 349 F.2d 87, 89 (1965), that:

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * *" as argued by the executors.

Judge Halpern further observed that the Tax Court majority fails to explain "how we might be justified in declining to take into account material limitations on a surviving spouse's right to income" and is thus inconsistent with the Treasury regulations under Section 2056 (App., *infra*, 64a, citing 26 C.F.R. 20.2056(b)-4(a)).

Judge Beghe agreed with the dissenting opinion of Judge Halpern (App., *infra*, 70a). Judge Beghe noted that numerous appellate decisions, as well as academic and professional writings, have agreed with the Commissioner's interpretation of these statutory provisions (App., *infra*, 77a-78a). He stated that the Tax Court's inconsistent and erroneous position "stands virtually alone on this issue" (*id.* at 77a).

6. A divided panel of the Eleventh Circuit affirmed (App., *infra*, 1a-23a). The majority did not explain its conclusions, electing instead to "simply attach" and adopt the relevant portion of the Tax Court opinion "as our own, as completely as if we had set it forth herein" (*id.* at 2a). The majority acknowleded that, having thus adopted the Tax Court opinion, its holding in this case "brings us in conflict with the two other circuits which have decided the issue" (*ibid.*, citing *Estate of Street* v. *Commissioner*, *supra*; *Burke* v. *United States*, *supra*). The majority added only that it agreed with the analysis of the Tax Court, rather than the conflicting analysis of the Sixth and Federal Circuits in *Estate of Street* and *Burke* (App., *infra*, 3a).

Judge Dubina dissented (App., *infra*, 18a-23a). He explained that the majority's holding "disregards fundamental federal estate taxation principles in light of state law, which allows administration expenses to be paid out of post-mortem income" (*id.* at 18a). The "fundamental federal estate taxation principle[]" disregarded by the majority is that "administration expenses, although unascertained on the date of death, are deemed to accrue at the decedent's death * * * [and] 'are charges against the gross estate'" (*id.* at 18a, 19a, quoting *Burke* v. *United States*, 994 F.2d at 1581). Judge Dubina noted (App., *infra*, 20a-23a) that the majority's holding conflicts not only with the decision of the Sixth Circuit in *Estate of Street* and the decision of the Federal Circuit in *Burke*; it also conflicts with the decisions of the Fifth Circuit in *Alston* v. *United States*, 349 F.2d 87 (1965), and in *Ballantine* v. *Tomlinson*, 293 F.2d 311 (1961), which held that the marital and charitable deductions are reduced by the amount of administration expenses even when these expenses are paid from post-death income.[4]

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[4] Judge Dubina noted (App., *infra*, 22a) that these older Fifth Circuit decisions are binding on the Eleventh Circuit (*Bonner* v. *City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc)) and should have been followed as circuit precedent in this case. The majority disagreed, stating that the provisions of state law involved in the *Alston* and *Ballantine* cases differed from the Georgia probate provisions involved in this case (App., *infra*, 4a n.1).

As Judge Dubina explained (App., *infra*, 21a), *Alston* and *Ballantine* hold that "administration expenses must be deducted from the gross estate even though paid out of post-mortem income." 349 F.2d at 89. See 293 F.2d at 313. Judge Dubina noted (App., *infra*, 22a) that, in *Ballantine*, the court of

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals creates a direct conflict among the circuits on a recurring matter of substantial importance in the administration of the federal estate tax.

1. As the court of appeals acknowledged (App., *infra*, 2a), its decision in this case directly conflicts with the decisions of the Sixth Circuit in *Estate of Street* v. *Commissioner*, 974 F.2d 723 (1992), and the Federal Circuit in *Burke* v. *United States*, 994 F.2d 1576, cert. denied, 114 S.Ct 546 (1993). As Judge Dubina further explained in his dissent (App., *infra*, 20a-23a), the decision in this case also conflicts with the decisions of the Fifth Circuit in *Alston* v. *United States*, 349 F.2d 87 (1965), and *Ballantine* v. *Tomlinson*, 293 F.2d 311 (1961).[5]

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appeals explained that the Commissioner's interpretation of Section 2056 is supported by the legislative history of the statute. The Senate Report accompanying the legislation states (S. Rep. No. 1013, 80th Cong., 2d Sess. Pt. 2, at 6 (1948)):

> The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest.

As Judge Dubina noted (App., *infra*, 22a), and as the Fifth Circuit held in *Ballantine*, the term "claims" in this legislative history necessarily encompasses administration expenses because "[t]he reason for including the one applies to the other." 293 F.2d at 313.

[5] The decision also conflicts with the decision of the Fifth Circuit in *Estate of Roney* v. *Commissioner*, 294 F.2d 774 (1961), aff'g per curiam 33 T.C. 801 (1960).

As the courts of appeals had consistently held prior to the decision in this case, when a marital or charitable bequest is burdened by the obligation of paying administration expenses of the estate, the present "value" of the marital or charitable interest as of the date of death is diminished by that obligation. As these courts have concluded, the necessary consequence of that diminution in value is that the marital or charitable deduction is reduced commensurately under Sections 2055 and 2056 of the Code. And, as the courts had futher consistently held, this conclusion is equally correct whether the administration expenses are paid directly from the principal, or from the income, of the estate that would otherwise be paid to the marital or charitable interests. See, *e.g.*, *Estate of Street* v. *Commissioner*, 974 F.2d at 726-728; pages 10-11 & note 2, *supra*.[6]

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[6] The Tax Court (and thus the court of appeals) erred in concluding (App., *infra*, 39a) that the amount of federal tax deductions depends on whether state law permits administration expenses to be charged to post-death income. Although state law is determinative of property rights, federal law determines the manner and extent to which such rights are taxed. *Morgan* v. *Commissioner*, 309 U.S. 78, 80 (1940); *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932); *Burke* v. *United States*, 994 F.2d at 1580; *Murray* v. *United States*, 687 F.2d 386, 392 n.3 (Ct. Cl. 1982). As this Court explained in *Lyeth* v. *Hoey*, 305 U.S. 188, 194 (1938):

> In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, shall be interpreted "so as to give a uniform application to a nationwide scheme of taxation." Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law [citations omitted].

In the present case, the relevant sections of the Internal Revenue Code do not "by express language or necessary implication make[] its operation dependent upon state law." *Ibid.* Instead, as the Federal Circuit explained in *Burke* v. *United States*, 994 F.2d at 1581, "[a]lthough section 2053 permits state law to determine what administrative expenses are 'allowable,' how section 2053 treats the allowable administrative expenses for estate tax deduction purposes is a federal question." See also *Estate of Street*, 974 F.2d at 728.

The federal estate tax is a tax imposed on the transfer of the decedent's estate; it is not an inheritance tax on the receipt of property by the beneficiaries. *Ithaca Trust Co.* v. *United States*, 279 U.S. 151, 155 (1929); *YMCA* v. *Davis*, 264 U.S. 47, 50 (1924). See 26 U.S.C. 2001(a). The estate cannot be transferred without incurring administration expenses, and Section 2053(a)(2) of the Internal Revenue Code expressly authorizes a deduction for administration expenses. The pertinent Treasury Regulation defines "administration expenses" as "such expenses as are actually and necessarily, incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it." 26 C.F.R. 20.2053-3(a). Such administration expenses are an encumbrance on the gross estate that exists at the date of death, even though the amount of these expenses is not then ascertainable. When that encumbrance falls upon the portion of the estate that comprises the marital or charitable bequest, it reduces the value of that bequest and therefore

reduces the marital or charitable deduction under Sections 2055 and 2056. See, *e.g.*, *Ballantine* v. *Tomlinson*, 293 F.2d at 312-313:

> At the decedent's death his estate had the obligation of paying estate taxes, debts, charges and expenses of administration. * * * It follows then that the legacy to the decedent's spouse * * * was charged, at his death, with a like part of the expenses of administration, even though the amount of such expense might not be then ascertainable.

Accord *Alston* v. *United States*, 349 F.2d at 88; *Estate of Roney*, 33 T.C. at 804 (the fact that administrative expenses are paid out of the income generated by the residuary estate after death does not "relieve the residuary legacy, for valuation purposes, of that burden or encumbrance for such expenses"). As was explained in *Burke* v. *United States*, 994 F.2d at 1581 (opinion of Chief Judge Nies):

> Section 2051 defines the taxable estate and the deductions used to determine the taxable estate in terms of the gross estate. * * * Likewise, section 2053, by its plain language, defines the deduction for administrative expenses in terms of the gross estate. Reading sections 2031, 2051, and 2053 together, the gross estate, which is the value of the decedent's estate at the time of death, is the sole source from which the administrative expenses may be deducted. Thus, the deduction of administrative expenses as provided for by federal law—as opposed to the actual payment of administrative expenses as allowed under state law—must come from, i.e., be accounted for within, the gross estate.

See also *Ballantine* v. *Tomlinson*, 293 F.2d at 312. As the Fifth Circuit stated in *Alston* v. *United States*, 349 F.2d at 89, in holding that the use of estate income to pay administration expenses diminishes the value of the residuary bequest and therefore reduces the charitable deduction under Section 2055:

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * *" as argued by the executors.

The contrary conclusion of the court of appeals and the Tax Court in the present case not only contradicts the logic and language of the statute, it is also inconsistent with the longstanding Treasury regulations under Section 2056. Those regulations specify that any "material limitation" on the spouse's right to receive income from the marital bequest reduces the "value" of the bequest and therefore commensurately reduces the marital deduction under the statute. 26 C.F.R. 20.2056(b)-4(a).[7] As Judge Halpern explained in dissent in the Tax Court, the decision in this case conflicts with this regulation because the obligation to pay administration expenses from the residuary estate is quite clearly a "material limitation[] on a surviving spouse's right to income" that she would otherwise have received (App., *infra*, 64a). Indeed, on the facts of the present case, the

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[7] As Judge Dubina explained in dissent in the court of appeals, that interpretation of the statute is supported by its legislative history. See note 4, *supra*.

burden from that obligation exceeded $2,000,000 (*id.* at 3a).

The decision of the Eleventh Circuit in this case rejects a long and consistent line of regulatory and judicial interpretations of these statutory provisions. By joining the Tax Court, which previously stood "virtually alone on this issue" (App., *infra*, 77a (Judge Beghe, J., dissenting)), the court of appeals has created a conflict among the circuits on a question of substantial administrative importance.[8]

2. The question whether administration expenses paid out of estate income reduce the marital and charitable deductions in the calculation of the federal estate tax is a question that commonly arises and—as the numerous appellate and lower court decisions on this issue reflect—is frequently litigated.[9] Indeed, this question arises either actually or potentially for any estate that contains a bequest to a spouse or charity when, as is customarily the case for residuary bequests, that bequest is burdened by the obligation that it provide for the payment of administration expenses. The question thus arises in countless cases.

In the absence of a decision by this Court resolving the conflict among the courts of appeals, the treatment afforded to estates that claim marital and charitable deductions will differ based solely upon geographic happenstance. Resolution of this recurring question by this Court is needed to avoid continuing uncertainty and to assure even-handed application of the revenue laws.

[8] The court of appeals explicitly acknowledged the circuit conflict, and its denial of the government's rehearing petition and suggestion that the case be reheard en banc solidified the conflict.

[9] This question has been litigated in numerous cases that have not been appealed. See, *e.g.*, *Fisher* v. *United States*, 28 Fed. Cl. 88 (1993); *Estate of Horne* v. *Commissioner*, 91 T.C. 100 (1988); *Estate of Richardson* v. *Commissioner*, 89 T.C. 1193 (1987); *Rifkind* v. *United States*, 5 Cl. Ct. 362 (1984).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MARCH 1996

APPENDIX A

UNITED STATES COURT OF APPEALS
ELEVENTH CIRCUIT

No. 94-8287

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA), N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,
PETITIONERS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLANT

APPEAL FROM A DECISION OF THE UNITED STATES TAX COURT (GEORGIA CASE)

Sept. 12, 1995

Before: DUBINA, Circuit Judge, RONEY and ESCHBACH*, Senior Circuit Judges.

RONEY, Senior Circuit Judge:

On appeal by the Government in this estate tax case, we affirm the United States Tax Court holding that the marital and charitable deductions are to be

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* Honorable Jesse E. Eschbach, Senior U.S. Circuit Judge for the Seventh Circuit, sitting by designation.

reduced only by the portion of administration expenses allocated to principal and not by amounts allocated to income. *Estate of Otis C. Hubert v. Commissioner of Internal Revenue*, 101 T.C. 314, 1993 WL 414716 (1993). This holding brings us in conflict with the two other circuits which have decided the issue. *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir.1992); *Burke v. United States*, 994 F.2d 1576 (Fed.Cir.), cert. denied, — U.S. —, 114 S.Ct. 546, 126 L.Ed.2d 448 (1993). The Tax Court, in a reviewed decision, concurred in by 15 of the 17 Tax Court judges, specifically declined to accept the reasoning in *Street* in a comprehensive opinion.

Since the Tax Court wrote a careful analysis of every argument that is made by the Commissioner on this appeal, and we agree with the reasoning in that opinion, we simply attach that part of the opinion found at 101 T.C. at 320-30 as an Appendix and adopt it as our own, as completely as if we had set it forth herein.

We note just four points that may assist in understanding the analysis made in the portion of the Tax Court opinion attached.

First, the Tax Court was confronted with other issues not raised on this appeal so that the portion attached deals only with the issue on this appeal. Critical to understanding that opinion, however, is the following footnote on page 2 of the original opinion:

> We are using the terms "marital portion" and "charitable portion" to mean the amounts received by the spouse and the charity, respectively, under the settlement agreement. Pursuant to the settlement agreement, the marital and charitable portions include income accumulated to the date of distribution. The terms "marital portion" and "charitable portion" should not be confused with the terms "marital share" and "charitable share" or "marital deduction" and "charitable deduction." 101 T.C. at 350 n. 1.

Second, this case involves the $30,000,000 estate of Otis C. Hubert, a Georgia resident. There was considerable other litigation in connection with the estate. The settlement agreement referred to in the portion of the opinion published here was the result of some prior litigation.

Third, Georgia law authorizes allocation of expenses to income rather than principal, if the will so provides. Ga.Code Ann. §§ 53-2-101, 53-15-3 (Michie 1982). Hubert's will authorized such an allocation. See *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir.1993) (allocation of administrative expenses to income allowed by state law did not reduce the charitable deduction).

Fourth, the estate included a generous amount of income producing property. From 1986 until 1991, the estate generated over $4,500,000 of income and incurred over $2,000,000 in administration expenses. The executors allocated $506,989 to the principal of the estate and paid the rest of the administration expenses from post-death income and deducted it on the estate's income tax returns.

Our reasons for disagreeing with the Sixth Circuit's analysis in *Street* are the same as those which addressed that case in the Tax Court opinion. The later decided case of *Burke* by the Federal

Circuit simply relied on *Street* and added nothing new to the discussion.[1]

AFFIRMED.

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[1] With due respect to the dissenting opinion, the two cases cited as binding authority are inapplicable to this case.

In *Ballantine v. Tomlinson*, 293 F.2d 311 (5th Cir.1961), neither the will nor Florida law permitted the expenses there involved to be paid out of income. "The decedent, by his will directed that the wife's share of the residuary estate should not be charged with any part of the estate tax. *There was no such provision or other direction with respect to administration expenses or other charges against the estate.*" (emphasis added). 293 F.2d at 312. "[W]e find nothing in the Florida statutory law requiring payment of administration expenses from estate income. We are likewise unable to agree . . . (that a state case) . . . requires that administration expenses be paid from estate income." 293 F.2d at 314. Unlike *Ballantine*, the Georgia law in this case provided for the payment of these expenses from income if the will permitted.

Likewise in *Alston v. United States*, 349 F.2d 87 (5th Cir.1965), though Georgia law permitted it, there was no provision in the will for the payment of the administration expenses there involved from income. Georgia law required them to be paid from the residue of the estate. "Although there is no specific reference in Georgia statutes to administration expenses as such, there are provisions that, *unless otherwise directed*, debts should be paid out of the residuum." (emphasis added). 349 F.2d at 88.

There is nothing in either opinion that would indicate a result contrary to the one the tax court reached in this case.

APPENDIX

Estate of Otis C. Hubert, Deceased, C & S/SovranTrust Company (Georgia), N.A., A National Banking Association, Co-Executor, *PETITIONER*, *v.* Commissioner of Internal Revenue, *RESPONDENT* (Docket No. 22333-90, October 19, 1993, 101 T.C. 314, 320-30 [1993 WL 414716]).

Allocation of Expenses

The second issue for decision is whether the marital and charitable deductions must be reduced by expenses allocated to income of the estate.

The 1982 will gave the executors of decedent's estate the power "to charge any expenses against income or principal or apportion the same." The executors allocated $506,989 as funeral and administration expenses to the principal of the estate. All other administration expenses were allocated to income.

Respondent argues that the amount of a marital or charitable deduction must be reduced by the entire amount of administration expenses, whether those expenses are allocated to principal or to income. Respondent cites section 20.2056(b)-4(a), Estate Tax Regs., and the legislative history of section 2056 as support for the proposition. In addition, respondent argues that the courts have "uniformly recognized" that administration expenses reduce the marital and charitable deductions regardless of whether those expenses are paid out of income or principal. Respondent contends that both Georgia law and the language of the settlement agreement also mandate such a result. We disagree.

Before considering this issue in detail, it is helpful to consider an overview of the operation of estate accounting and estate taxes. The starting point for determining Federal estate taxes is the date-of-death (or alternate valuation date) value of the property of the estate. Deductions are allowed for various expenses of the estate, as well as for claims against the estate and bequests to the decedent's spouse and to charity. Income earned by the estate has no effect on the estate for Federal estate tax purposes. It is accounted for separately in the estate's probate account and is taxed separately on the estate's Forms 1041.

Executors have been granted significant flexibility in accounting for the estate's administration expenses, both for estate and income tax purposes, and for probate accounting purposes. Congress has granted the executor the option of deducting administration expenses on either the estate return, Form 706, or the fiduciary income tax return, Form 1041. Sec. 642(g). In addition, many States give the decedent the option of authorizing the executor to allocate such expenses to principal or to income at the executor's discretion. If the administration expenses were paid out of principal, they would reduce the amount of such principal received by the beneficiaries and would reduce the marital and charitable deductions. However, we conclude that the administration expenses that are allocable to income in this case do not change the amount of the estate principal received by the spouse or the charity and do not reduce the marital and charitable deductions. Administration expenses are incurred and accrue during administration and should not be confused with the claims against the estate which existed and accrued at the date of death.

Our conclusion that the marital and charitable deductions are not reduced by payment of administration expenses allocated to income does not lead to a double deduction in violation of section 642(g). Section 642(g) prohibits a deduction under section 2053 or 2054 for any administration expenses deducted on the estate's income tax return. However, section 642(g) does not prohibit or reduce deductions under section 2055 or 2056. The deductions under sections 2055 and 2056 are based on the date-of-death value of the property received by the charity and the spouse from the gross estate. The executor's ability to preserve the value of the marital and charitable bequests by allocating administration expenses to income is in no way barred by section 642(g).

The allocation of the expenses in the case before us is governed by Georgia law. Georgia law authorizes allocation of expenses to income rather than principal, if provided in the will. Ga.Code Ann. §§ 53-2-101, 53-15-3 (Michie 1982). The 1982 will authorized such an allocation, and this provision was not affected by the settlement agreement. To the extent the executor exercised its discretion and allocated administration expenses to income, the marital and charitable deductions are not reduced by payment of those expenses.

Respondent argues that section 20.2056(b)-4(a), Estate Tax Regs., controls this question. That section states, in relevant part:

> Marital deduction; valuation of interest passing to surviving spouse.—(a) *In general.* * * * The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse,

> the same principles being applicable as if the amount of a gift to the spouse were being determined. *In determining the value of the interest in property passing to the spouse* account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate. [Emphasis added.]

We do not interpret section 20.2056(b)-4(a), Estate Tax Regs., as mandating a setoff against the marital deduction for administration expenses allocable to income. That section is merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse. The fact that income from property is to be used to pay expenses during the administration of the estate is not necessarily a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate.

On the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. Under section 2056(b)(4) and section 20.2056(b)-4(a), Estate Tax Regs., the value of the interest passing to the spouse and the effect of any encumbrance on that interest shall be determined "as if the amount of a gift to the spouse were being

determined." Therefore, we look to the gift tax provisions and consider how they treat the payment of expenses out of the income of a trust that was given to a spouse. Under section 2523(e), in order for a donor to be entitled to a deduction for a gift in trust to his spouse over which the spouse has a general power of appointment, the spouse must be entitled to all of the income from the trust. Under section 25.2523(e)-1(f)(3), Gift Tax Regs., a spouse is considered to receive all of the income from a trust even if "trustees' commissions, and other charges" are paid out of income, provided the spouse is not deprived of substantial beneficial enjoyment. That section is similar to section 20.2056(b)-(5)(f)(3), Estate Tax Regs. In interpreting those sections, respondent has considered the effect of a power "To charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses" on the marital deduction. Respondent concluded that such a power "does not result in the disallowance or *diminution* of the marital deduction." Rev.Rul. 69-56, 1969-1 C.B. 224 (emphasis added). While we recognize that the revenue ruling is not binding precedent, it does present respondent's position on this subject. *Crow v. Commissioner*, 85 T.C. 376, 389 [1985 WL 15387] (1985).

In the case before us, the power is essentially the same as the power in the revenue ruling. Moreover, the income used to pay administration expenses is insubstantial compared to the lifetime of income Mrs. Hubert will receive from the property. Therefore, she is not deprived of substantial beneficial enjoyment, and she would be treated, under section 25.2523(e)-1(f)(3), Gift Tax Regs., as having received

all of the income from the trust. If Mrs. Hubert is treated as having received all of the income from the trust, there can be no material limitation on her right to receive income.

We also reject respondent's interpretation of the legislative history of the marital deduction, which states that *claims* against the estate paid out of income increase the residue by purchase, not bequest, and therefore "the value of any such additional part of the residue passing to the surviving spouse can not be included in the amount of the marital deduction." S.Rept. 1013 (Part II), 80th Cong., 2d Sess. (1948), U.S.Code Cong. and Admin.News 1948 p. 1163, 1228, 1948-1 C.B. 331, 335. The Senate report describes the result only if income is use to pay *claims against the estate*; it does not discuss administration expenses at any point. There is a clear distinction between claims against the estate and administration expenses which are allocable to income, and this distinction mandates different treatment of the two. Claims against the estate are, by definition, in existence at the date of death; therefore, by their very nature, claims against the estate relate to corpus and must be charged thereto. By contrasts, administration expenses come into existence only after the death of the decedent and may relate to both income and corpus. As a result, administration expenses logically can be charged to either income or corpus. Here they were charged to income in accordance with the will and Georgia law. Accordingly, the legislative history cited by respondent does not control the treatment of administration expenses in the case before us.

This Court has spoken on this issue in *Estate of Richardson v. Commissioner*, 89 T.C. 1193 [1987 WL 257908] (1987), and *Estate of Street v. Commissioner*, T.C.Memo 1988-553 [1988 WL 128662], aff'd in part and rev'd in part, 974 F.2d 723 (6th Cir.1992). In *Estate of Richardson*, the decedent left to his wife the amount of his residuary estate necessary to maximize all of his estate tax deductions in order to make his estate nontaxable for Federal estate tax purposes. The decedent's executors were given the power to allocate expenses between income and principal. Respondent argued that the marital deduction should be reduced by the amount of interest payable on the estate's Federal estate taxes and State inheritance taxes, even though the executors had allocated the interest to income.

We concluded: "Whether an expenditure on behalf of an estate is chargeable to principal, or the income produced thereby, depends on the law of the State wherein decedent was a resident at the time of his death, or upon the terms of decedent's will." *Estate of Richardson v. Commissioner, supra* at 1201. In that case, there were no provisions of State law dictating where the interest should be charged. Therefore, we looked to the language of the will and determined that, based on the decedent's intent to minimize taxes, the executors had the power to charge the interest against income and, thereby, not reduce the marital deduction.

In *Estate of Street*, on similar facts we held that Tennessee law permitted a decedent to grant the power to allocate administration expenses between income and principal. We held that the marital deduction was not reduced by the amount of the expenses allocated to income.

We note that the fact that the marital bequest in *Estate of Street* was in trust did not affect our reasoning in that case. Respondent argues that the fact of the trust should make a difference, because if Mrs. Hubert is receiving only an income interest and part of the income is used to pay expenses, the value of the interest passing to Mrs. Hubert is reduced. However, respondent ignores the fact that, because Mrs. Hubert has a general power of appointment over one of the trusts and the other trust is a qualified terminable interest trust, Mrs. Hubert is treated as having received the entire value of both trusts, not just the income portions.

On appeal, the Court of Appeals for the Sixth Circuit reversed our holding in *Estate of Street* with regard to administration expenses, concluding that payment of such expenses reduces the marital deduction whether the payment is allocated to income or to principal. However, the court upheld our holding that the payment of interest on estate taxes and inheritance taxes allocated to income does not reduce the marital deduction. *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir.1992), aff'g in part, rev'g in part and remanding.[4]

On the issue of the administration expenses, the Court of Appeals determined that section 20.2056(b)-4(a), Estate Tax Regs., was controlling. The Court of

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[4] Respondent has now accepted the holding that the payment of interest on estate and inheritance taxes allocated to income does not reduce the marital deduction. Rev.Rul. 93-48, 1993-25 I.R.B. 9. Respondent has specifically limited her change in position to payments of interest and has reaffirmed her position regarding all other administration expenses. As we explain below, we see no valid distinction between interest and other administration expenses.

Appeals concluded that the regulation mandates a setoff against the marital deduction for administration expenses paid from income. The court reasoned:

> Income earned by the estate during * * * [the administration] period builds up the marital share. Expenses paid from income during this period have the effect of decreasing the amount of estate property distributable to the spouse. Therefore, the payment of administration expenses from income must operate to reduce the size of the marital deduction, otherwise the spouse would receive a deduction which exceeded the amount which was actually in the estate, and available for distribution. * * * [*Id.* at 727].

The court found support for this reasoning in the legislative history of the marital deduction.

The Court of Appeals distinguished administration expenses from interest on estate and inheritance taxes on two grounds. First, citing *Estate of Richardson*, the court stated that the interest on taxes accrues after death, whereas administration expenses "accrue at death." As a result, the court determined that payment of interest on taxes from estate income does not affect the principal of the estate as it existed at the time of decedent's death, but payment of administration expenses from such income "will serve to build up the gross estate." *Id.* at 727. Second, the court noted that section 20.2056(b)-4(a), Estate Tax Regs., specifically mentions administration expenses in it example, but it does not mention interest on taxes. Therefore, the court held that the regulation was inapplicable to interest on taxes. *Id.* at 729. Thus, the Court of Appeals

concluded that payment of administration expenses from income of the estate should reduce the marital deduction, but payment of interest on estate and inheritance taxes from income should not reduce the marital deduction. See also *Burke v. United States*, 994 F.2d 1576 (Fed.Cir.1993), and *Fisher v. United States*, 28 Fed.Cl. 88 (1993), which rely on the rationale of *Estate of Street* with respect to administration expenses.

Respectfully, we disagree with the reasoning of the Court of Appeals and decline to follow its decision in *Estate of Street*. As stated above, we interpret section 20.2056(b)-4(a), Estate Tax Regs., to be a valuation provision. Therefore, unlike the Court of Appeals, we find that the regulation does not control the case before us. In addition, as noted previously, we conclude that the legislative history of the marital deduction does not mandate a different conclusion.

Moreover, we take issue with the Court of Appeals' analysis of the effect of income and expenses on the marital share. The court stated that income earned on estate property increases the marital share, and presumably the marital deduction, leading to a deduction greater than the amount distributed if payment of expenses from income does not reduce the marital deduction. However, income earned on estate property is not included in the gross estate. *Alston v. United States*, 349 F.2d 87 (5th Cir.1965). As a result, under section 2056(a), such income does not lead to an increase in the amount of marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate.

Finally, we disagree with the Court of Appeals' distinction between interest on estate and inheritance taxes and administration expenses. The fact that section 20.2056(b)-4(a), Estate Tax Regs., explicitly refers to administration expenses but does not mention interest on taxes is not relevant because the reference to administration expenses is "*An* example of a case in which this rule *may* be applied." Sec. 20.2056(b)-4(a), Estate Tax Regs. (emphasis added). Application of the regulation, when appropriate, is clearly not limited to administration expenses. Regardless of the regulation's treatment of administration expenses and interest on taxes, it does not provide a useful distinction between the two.

In addition, administration expenses and interest on taxes cannot be distinguished according to the time at which they accrue. Both accrue after the date of death. Administration expenses, by their very nature, are incurred over the entire period of the estate's administration and can vary significantly from estate to estate. As a result, administration expenses are too uncertain at the date of death to accrue at that time. Our analysis in *Estate of Richardson v. Commissioner*, 89 T.C. 1193 [1987 WL 257908] (1987), therefore applies to administration expenses as well as to interest on taxes, and we will follow our holding in that case.

Both respondent and the Court of Appeals cite *Estate of Roney v. Commissioner*, 33 T.C. 801 [1960 WL 1078] (1960), aff'd, 294 F.2d 774 (5th Cir.1961), as support for their positions. In *Estate of Roney*, the decedent left the residue of his estate to his wife. The will made no provision as to the source of payment of administration expenses. The executor deducted the administration expenses on the estate's fiduciary income tax returns and did not reduce the marital deduction on the estate tax return by the amount of

those expenses. In that case, we looked to Florida law and determined that the executor was required to pay administration expenses out of the residuary estate. Since the residuary estate does not include income, we determined that the marital deduction should be reduced by the amount of the expenses because the amount of principal received by the spouse was reduced to that extent.

The holding in *Estate of Roney* is not inconsistent with the result we reach in the case before us. We merely held in *Estate of Roney* that when administration expenses are required to be allocated to principal, the marital deduction is reduced by the amount of those expenses. Whether the deduction for the administration expenses is taken on Form 706 or Form 1041 is immaterial and irrelevant. See also *Alston v. United States*, *supra*.

Although *Estate of Wycoff v. Commissioner*, [59] T.C. 617 [1973 WL 2679] (1973), aff'd, 506 F.2d 1144 (10th Cir.1974), was not cited by either party, we find it appropriate to discuss that case here. In *Estate of Wycoff*, the decedent's will provided:

> all inheritance, estate and transfer taxes due by reason of my death shall be paid out of that portion of my estate which is not included in the Marital Trust to be administered by my Trustee, unless, in the best business judgment and sole discretion of my executor, such taxes could be more prudently paid from any assets in my estate without respect to what is or is not included in the Marital Trust * * * [*Id.* at 619.]

Based upon the above election available to the executor, we concluded that the marital trust might be charged with those taxes and that the marital

deduction was accordingly reduced. We distinguish that case on its facts.

The executor's choices in *Estate of Wycoff* were between two shares of the estate, the marital trust and the nonmarital trust, both of which were included in the gross estate, and not between principal and income, where only principal would be included in the gross estate and income would be accounted for and taxed separately, as noted above.

We decline to read *Estate of Wycoff* more broadly to make the result depend entirely on the discretion of the executor. We will confine *Estate of Wycoff* to its facts and to the more narrow interpretation which we believe was intended by the Court.

Respondent cites Ga.Code Ann. section 53-2-101 (Michie 1982) as support for the contention that Georgia law requires expenses to be allocated to principal rather than income. However, that section only requires allocation of expenses to the principal if no other provisions are made by the will. Ga.Code Ann. section 53-15-3 (Michie 1982) allows decedents to grant their executors the power to allocate expenses between principal and income. Decedent, in this case, clearly granted such power to his executors.

Finally, we conclude that the settlement agreement did not alter decedent's grant of the power to allocate expenses. The settlement agreement merely set forth a formula for determining the final amounts of both income and principal to be received by Mrs. Hubert and the charity. That this is the case is demonstrated by the fact that both parties agree the marital portion, as calculated under the settlement agreement, should be reduced by income in order to determine the marital deduction. The fact that the settlement agreement provided for allocation of

expenses between the marital and charitable portions does not preclude the executors from allocating those expenses to income rather than principal within those portions pursuant to the 1982 will.

Respondent cites a variety of cases in support of the contention that the marital and charitable deductions must be reduced by expenses. However, none of those cases is on point. They deal with situations in which the will made no provision for the allocation of expenses and, therefore, the statute controlled the allocation. Here, we clearly have a provision in the will which controls the allocation.

We hold that the allocation of petitioner's expenses to income was permitted by Georgia law, and the marital and charitable deductions are not reduced by expenses so allocated.

DUBINA, Circuit Judge, dissenting:

I.

Because I am convinced that the majority has erred in adopting the Tax Court's analysis in this case, I respectfully dissent. I disagree with the majority's holding for two reasons: First, the holding disregards fundamental federal estate taxation principles in light of state law, which allows administration expenses to be paid out of post-mortem income, and second, it contravenes binding circuit precedent.

II.

In this case, both the decedent's will and relevant state law allowed administrative expenses to be paid out of post-mortem income; however, "the allowable sources of payment for administration expenses under state law does not necessarily affect the source

from which the deduction for administrative expenses must be made under federal law." *Burke v. U.S.*, 994 F.2d 1576, 1580 (Fed.Cir.) (emphasis in original), *cert. denied*, — U.S. —, 114 S.Ct. 546, 126 L.Ed.2d 448 (1993) (citing *Lyeth v. Hoey, Collector of the Internal Revenue*, 305 U.S. 188, 193-94, 59 S.Ct. 155, 158, 83 L.Ed. 119 (1938)).

Section 2031 of the Internal Revenue Code ("I.R.C.") defines the value of the gross estate as "the value at the time of [the decedent's] death."[1] At the decedent's death, the estate has the obligation to pay administration expenses. I.R.C. § 2053; *Ballantine v. Tomlinson*, 293 F.2d 311, 312 (5th Cir.1961).[2] Also, contrary to the Tax Court's assertion, administration expenses, although unascertained on the date of death, are deemed to accrue at the decedent's death. *Alston v. United States*, 349 F.2d 87, 88 (5th Cir.1965) ("at the decedent's death his estate had the obligation of paying estate taxes, debts, charges and expenses of administration") (citation omitted). *See also Estate of Street v. Commissioner*, 974 F.2d 723, 727 (6th Cir.1992). "[R]egardless of the source of payments for administration expenses, such payments are charges against the gross estate and must be accounted for accordingly." *Burke*, 994 F.2d at 1581 (citing *Estate of Street*, 974 F.2d at 728-29; *Alston*, 349 F.2d at 88; *Rifkind v. United States*, 5 Cl.Ct. 362, 374 (1984)).

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[1] I.R.C. §2032 provides an alternative valuation scheme which is not relevant to this case.

[2] In *Bonner v. City of Prichard*, 661 F.2d 1206, 1209 (11th Cir.1981), this court adopted as binding precedent all decisions of the former Fifth Circuit handed down prior to October 1, 1981.

Using income to pay administration expenses can be of great benefit to an estate, especially where no other liquid assets are available to pay the expenses; yet, income earned by an estate during administration is not part of the gross estate. *See Alston*, 349 F.2d at 88; *Fisher v. United States*, 28 Fed.Cl. 88 (Fed.Cl.1993). Allowing administration expenses to be paid out of income earned during the administration of the estate, without reducing the gross estate by the amount of the charges against it, has the effect of increasing the gross estate by the amount of post-mortem income. See *Alston*, 349 F.2d at 89.

III.

The *Alston* case is binding precedent. At the time *Alston* was decided, state law required administration expenses to be paid out of the residuum of the estate.[3] The holding of *Alston*, however, was based upon an interpretation of the statutory definition of the gross estate, which is a matter of federal law. *See id.*

In *Alston*, the residue of the decedent's estate was left to a qualified charity. The executors of the estate filed an estate tax return with a gross estate of approximately $5.9 million. One thousand forty-two dollars and forty-one cents ($1,042.41) in funeral and administration expenses were deducted along with other deductions, leaving an amount of approximately $4.4 million in residue for the charitable deduction. *Id.* at 88. The next year, the executors filed the estate's income tax return, claiming administration

[3] There was no specific state statute regarding administration expenses, but the court determined that the source of payment of the expenses was the residuum of the estate.

expenses totalling $66,827.33 as deductions. The executors had charged this amount against the estate's principal account. Because the executors had failed to deduct these administration expenses from the gross estate in computing the residue for the charitable deduction, the Commissioner asserted an estate tax deficiency. Thereafter, the executors changed their book entries to charge the expenses to the estate's income, rather than the principal, paid the deficiency, and instituted a suit to recover the amount of the deficiency. *Id.*

The executors argued that "where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments." *Alston*, 349 F.2d at 89. The court rejected the executors' argument and held that the source of the deduction was the gross estate and that "administration expenses must be deducted from the gross estate even though paid out of post-mortem income." *Id. See also Ballantine*, 293 F.2d at 313 (the gross estate must be reduced by the amount of the administration expenses even though those expenses are met from another source). The court reasoned that the "effect of yielding to the executors' argument here would be to increase the amount of the gross estate by the amount of post-mortem income—a result directly contrary to the *statutory definition of gross estate*." *Alston*, 349 F.2d at 89 (emphasis added).

We are bound by the *Alston* court's interpretation of federal law. Moreover, we are bound by precedent which specifically rejects the Tax Court's interpretation of the relevant legislative history of the marital deduction. *See Ballantine*, 293 F.2d at 313. The legislative history provides:

> The interest passing to the surviving spouse from the decedent is only such interest as the decedent can give. If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, *claims* against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest.

S.Rep. No. 1013 (Part II), 80th Cong., 2d Sess. (1948), reprinted in 1948 U.S.C.C.A.N. 1163, 1228 (emphasis added). In the present case, the Tax Court erroneously held that administration expenses are not "claims" because they come into existence only after the death of the decedent. Going further, the court distinguished administration expenses from claims against the estate reasoning that administration expenses relate to both the corpus and the income of the estate. Therefore, the court held that the legislative history cited above does not control the treatment of administration expenses.

In *Ballantine*, a decision that is binding on this court, the court rejected the executors' argument that the term "claims" as used in the legislative history referred to debts and excluded administration expenses. Specifically, the court held that there was no "logical basis for such a narrow construction" and that "[t]he reason for including the one applies to the other." *Ballantine*, 293 F.2d at 313 (citation omitted). Thus, the majority's adoption of the Tax Court's interpretation of the legislative history contravenes binding circuit precedent setting forth what I believe is the more logical interpretation.

IV.

In sum, the precedent set forth in *Alston* and *Ballantine* should be followed in this case. As a consequence, the Tax Court's judgment in favor of the estate should be reversed.

Although state law in this case allows administration expenses to be paid out of income earned by the estate during administration, federal law requires the gross estate to be reduced by the amount of the administration expenses, irrespective of the source of the payment. Accordingly, the marital and charitable deductions should be reduced by the amount of administration expenses that were paid out of income earned by the estate during administration.

APPENDIX B

UNITED STATES COURT OF APPEALS
ELEVENTH CIRCUIT

No. 94-8287

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA), N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,
PETITIONER-APPELLEE

versus

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLANT

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF GEORGIA

[Filed Dec. 5, 1995]

ON PETITION(S) FOR REHEARING AND SUGGESTION(S) OF REHEARING EN BANC
(Opinion _____, 11th Cir., 19__, ____ F.2d ____).

Before: DUBINA, Circuit Judge, RONEY and ESCHBACH*, Senior Circuit Judges.

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* Honorable Jesse E. Eschbach, Senior U.S. Circuit Judge for the Seventh Circuit, sitting by designation.

PER CURIAM:

The Petition(s) for Rehearing are DENIED and no member of this panel nor other Judge in regular active service on the Court having requested that the Court be polled on rehearing en banc (Rule 35, Federal Rules of Appellate Procedure; Eleventh Circuit Rule 35-5), the Suggestion(s) of Rehearing En Banc are DENIED.

ENTERED FOR THE COURT:

/s/ Jack F. Dubina
JACK F. DUBINA
UNITED STATES CIRCUIT JUDGE

APPENDIX C

UNITED STATES TAX COURT

No. 22333-90

ESTATE OF OTIS C. HUBERT, DECEASED, C&S/SOVRAN TRUST COMPANY (GEORGIA), N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR, PETITIONER,

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed: Oct. 19, 1993]

OPINION

CLAPP, Judge:

Respondent determined a deficiency in petitioner's estate tax in the amount of $14,052,146. After concession by the parties, the remaining issues for decision are: (1) Whether the amounts of petitioner's marital and charitable deductions are limited to the amounts passing to the marital and charitable shares under the 1982 will and three codicils, or are the amounts actually passing under a settlement agreement to the marital and charitable shares as reduced by obligations charged to the respective shares; (2) whether the amounts of the marital and charitable deductions must be reduced by administration

expenses paid from the marital and charitable portions[1] under the settlement agreement, without regard to whether the estate allocated those expenses to income; and (3) whether the marital and charitable portions must be discounted by 7 percent per annum to take into account income deemed to be earned by the residue.[2]

This case was submitted fully stipulated under Rule 122. We incorporate by reference the stipulation of facts and attached exhibits. All section references are to the Internal Revenue Code as in effect at the date of decedent's death, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Petitioner is the Estate of Otis C. Hubert (decedent). Decedent was a resident of Marietta, Georgia, when he died on June 2, 1986. C&S/Sovran Trust Company (C&S) is the coexecutor of decedent's estate. On the date the petition was filed, C&S had its principal place of business in Atlanta, Georgia.

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[1] We are using the terms "marital portion" and "charitable portion" to mean the amounts received by the spouse and the charity, respectively, under the settlement agreement. Pursuant to the settlement agreement, the marital and charitable portions include income accumulated to the date of distribution. The terms "marital portion" and "charitable portion" should not be confused with the terms "marital share" and "charitable share" or "marital deduction" and "charitable deduction".

[2] The Court has severed, for decision in a separate opinion, *Estate of Hubert v. Commissioner*, T.C. Memo. 1993-482, the issue of whether bequests in the amount of $100,000 each to two subtrusts providing for the support of the missionary work of charitable organizations through two named individuals and for the establishment of foreign mission field medical clinics qualify for a charitable deduction.

At the time of his death, decedent was married to Ruth S. Hubert (Mrs. Hubert). The Huberts had four children: Richard N. Hubert, Marilyn Hubert Kemper, Judith Hubert Manning, and Deborah Hubert Jones.

In January 1982, decedent executed the last will to be signed prior to his death (the 1982 will). That will superseded his previous will, which had been executed in 1977. The 1982 will was modified three times by codicils executed between February 4, 1982, and June 8, 1983. Decedent's nephew, Robert H. Owen (Owen), drafted the will and the three codicils.

In addition to certain specific bequests, the 1977 will left, in trust, an amount equal to the maximum marital deduction; however, if the estate tax due from the estate (before application of any credits) were less than any credits available to the estate, the marital bequest was to be reduced to that amount which would cause the estate tax owed by decedent's estate (before application of any credits) to equal the total of all credits finally allowed. Decedent's intent was to fully utilize all credits and deductions. The income from the trust was payable to Mrs. Hubert for her life, with the remainder to charity. Mrs. Hubert had a general power of appointment over the trust. The 1977 will also established a charitable remainder unitrust from the residue of the estate. The trustee had the discretion to distribute 5 percent of the net assets of the charitable trust annually to Mrs. Hubert or any of the Hubert children. Upon the death of Mrs. Hubert, the charitable trust terminated, and the remainder was to be distributed outright to charity.

The 1982 will left the residue of decedent's estate in trust, the income of which was to be paid to Mrs. Hubert, with the remainder to charity. Mrs. Hubert had a general power of appointment. The second codicil to the 1982 will eliminated Mrs. Hubert's general power of appointment.

Upon decedent's death, will contests were filed by various members of the Hubert family, including Mrs. Hubert. The will contest instituted by Mrs. Hubert requested the Probate Court to strike the second codicil to the 1982 will or, in the alternative, to strike the 1982 will and all the codicils, because of alleged undue influence by Owen in favor of the charitable remainder beneficiaries. In June 1987, the Hubert family, Owen, and the district attorney for Cobb County, Georgia, where the will was being probated, entered into an "Agreement of Interested Parties" (the first agreement), which purported to resolve all of the differences among the competing interests under the will.

The Georgia revenue commissioner challenged the first agreement alleging that he was a necessary party to ensure that the charitable beneficiaries were treated fairly. As a result of negotiations, which included the Georgia revenue commissioner and the Georgia attorney general as representatives for the charities, the first agreement was supplanted by the "Second and Final Settlement Agreement" (settlement agreement) on October 10, 1990, which was approved by the Superior Court of Cobb County in an Order, Judgment, and Decree. The Cobb County Probate Court entered a final order adopting the Order, Judgment, and Decree as binding in its proceedings on November 28, 1990.

The settlement agreement amended the 1982 will and codicils by deleting item VIII, which disposed of the residuary estate, and all codicil provisions related to that item. In lieu thereof, the settlement agree-

ment added various provisions, including provisions for the division of the residuary estate between the marital and charitable portions and for the allocation of expenses between the marital and charitable portions. Under the settlement agreement, Mrs. Hubert was named beneficiary of a part of the residue in two trusts: The marital trust, over which she had a general power of appointment, and the QTIP trust. The charity received the rest of the residue outright.

Based on the first agreement, an estate tax return, Form 706, was filed on September 2, 1987. Respondent issued a notice of deficiency on August 31, 1990, disallowing $12,650,592 of the marital deduction and $12,502,655 of the charitable deduction, as well as making adjustments to the deduction for debts of the decedent and to the amount of adjusted taxable bequests.

Limitations on Deductions Based on the 1982 Will and Codicils

The first issue for decision is whether the marital and charitable deductions are limited by the amounts Mrs. Hubert and the charity would have taken under the 1982 will and codicils.

Marital Deduction

Section 2056(a) provides in pertinent part:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall * * * be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

In defining whether an interest in property has "passed from the decedent to his surviving spouse" in the context of a will contest, section 20.2056(e)-2(d)(2), Estate Tax Regs., states:

> If as a result of the controversy involving the decedent's will, or involving any bequest or devise thereunder, a property interest is assigned or surrendered to the surviving spouse, the interest so acquired will be regarded as having "passed from the decedent to his surviving spouse" only if the assignment or surrender was a bona fide recognition of enforceable rights of the surviving spouse in the decedent's estate. Such a bona fide recognition will be presumed where the assignment or surrender was pursuant to a decision of a local court upon the merits in an adversary proceeding following a genuine and active contest. However, such a decree will be accepted only to the extent that the court passed upon the facts upon which deductibility of the property interests depends. If the assignment or surrender was pursuant to a decree rendered by consent, or pursuant to an agreement not to contest the will or not to probate the will, it will not necessarily be accepted as a bona fide evaluation of the rights of the spouse.

Respondent argues that petitioner's marital deduction is limited to the lesser of the amount distributed to Mrs. Hubert under the settlement agreement or the amount that would have been so distributed under the 1982 will and codicils. Presumably, respondent's contention is that Mrs. Hubert did not have an enforceable right in decedent's estate

to any amount in excess of what she would have received under the 1982 will and codicils.

Petitioner argues that "(i) a good faith compromise of (ii) a *bona fide* will dispute, (iii) involving uncontested provisions of state law, is absolutely dispositive of the question of enforceable rights." Petitioner contends that, although a settlement agreement cannot definitively determine questions of law, it can conclusively resolve questions of fact. Petitioner concludes that, since the State law in this case is clear and the dispute is inherently factual, the settlement agreement should control.

In deciding whether a settlement agreement is a "bona fide recognition of enforceable rights of the surviving spouse in decedent's estate", this Court has looked to whether the agreement was made in good faith as the result of arm's-length negotiations. *Estate of Barrett v. Commissioner*, 22 T.C. 606, 611 (1954).

However, in *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), the Supreme Court held that a Federal court deciding the estate tax consequences of an attempted disclaimer was not bound by the State trial court's adjudication of the property rights involved. Citing *Erie R. Co. v. Tompkins*, 304 U.S. 64 (1938), the Court noted that "state law as announced by the highest court of the State is to be followed." *Commissioner v. Estate of Bosch*, *supra* at 465. Moreover, the Court explained that the State's intermediate appellate court decisions should be considered in deciding State law unless the Federal court is convinced that the highest court of the State would rule otherwise. Therefore, the Court concluded that a Federal court may not always be bound by the decision of the intermediate appellate court and

that "when the application of a federal statute is involved, the decision of a state trial court as to an underlying issue of state law should a fortiori not be controlling." *Id.* Finally, the Court explained:

> the underlying substantive rule involved is based on state law and the State's highest court is the best authority on its own law. If there be no decision by that court then federal authorities must apply what they find to be the state law after giving "*proper regard*" to relevant rulings of other courts of the State. In this respect, it may be said to be, in effect, sitting as a state court. [*Id.*; emphasis added; citation omitted.]

In light of the Supreme Court's decision in *Estate of Bosch*, courts have concluded that if the decision of a State trial court on a matter of State law is not binding for estate tax purposes, a good faith settlement of such an issue cannot be either. *Ahmanson Found. v. United States*, 674 F.2d 761, 774 (9th Cir. 1981). We agree. In deciding whether the surviving spouse has enforceable rights in decedent's estate, courts must look behind any settlement agreement to ensure that the claim on which it is based is valid. *Estate of Brandon v. Commissioner*, 828 F.2d 493, 499 (8th Cir. 1987), revg. and remanding 86 T.C. 327 (1986).

While we agree that we are not bound by the settlement agreement for our decision of Mrs. Hubert's enforceable rights, we conclude that the agreement should not be ignored here. We have looked at the adversarial or nonadversarial nature of the proceedings in the State courts to determine the weight to be given such settlement agreements. See *Estate of Sawyer v. Commissioner*, 73 T.C. 1 (1979) (Tax Court followed the decision of the Court of Appeals of

Ohio because the decision was the result of a bona fide adversary proceeding, and the Court could not conclude that the Supreme Court of Ohio would not follow the lower court decision); *Harrah v. Commissioner*, 70 T.C. 735, 754 (1978) (Tax Court followed the characterization of property in a settlement agreement approved by a Nevada divorce court because the Court believed "the Nevada Supreme Court would have approved the action taken by the divorce court had it been called upon to review it", emphasizing the adversarial nature of the settlement); *Estate of Rowan v. Commissioner*, 54 T.C. 633 (1970) (Tax Court disregarded the determination of property ownership made by the Superior Court of California where it was not the result of bona fide adversary litigation and made an independent determination of the facts and law).

The parties have stipulated that the settlement agreement was the result of a bona fide adversary proceeding. Under the settlement agreement, Mrs. Hubert received in value more than half of what she would have received if she had succeeded in having the second codicil declared invalid as the product of undue influence and substantially all of what she would have received if she had succeeded in having the 1982 will and codicils declared invalid as the products of undue influence. Moreover, this was a settlement among adverse parties with significant interests to protect in the litigation, including the Georgia attorney general and the Georgia revenue commissioner, whose right to participate in the litigation was litigated all the way to the Supreme Court of Georgia. The settlement agreement also was approved by the Superior Court of Cobb County. Under Georgia law a settlement agreement sustaining a will challenge can

be approved by the Superior Court only "after a hearing, notice of which shall be given as the court shall direct, at which evidence is introduced and at which the judge finds as a matter of fact that the caveat is meritorious." Ga. Code Ann. sec. 53-3-22(a) (Michie 1982).

In addition, this is not a circumstance in which respondent's interests were hurt by the compromise reached by the parties. If the probate of the estate had proceeded without challenge, and the estate tax return had been filed based on the 1982 will and codicils, Mrs. Hubert would have been entitled to an income interest for life, payable at least annually, in the entire residue of the estate. Therefore, petitioner could have made a QTIP election and been entitled to a deduction for the entire residue. We note that respondent has conceded that the second settlement agreement modified the 1982 will and codicil so that section 2056(b)(7)(B)(i)(III) does not bar the marital deduction. Since the estate would have been entitled to a full deduction for the residue under the 1982 will and codicils, there is no way that the parties could have acted in a manner contrary to respondent's interests.[3]

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[3] We note that the additional tax that would arise if respondent prevailed on this argument is the result of the inconsistent treatment given to settlement agreements in the regulations. If Mrs. Hubert did not have an enforceable right to all of what she received under the settlement agreement, petitioner would be entitled to deduct only the amount she would have received under the 1982 will and codicils. The rationale for the result is that any amount to which she did not have an enforceable right did not pass to her from decedent, but was given to her by the charity in exchange for dropping her challenge. However, under the regulations, petitioner is

Taking all of the circumstances surrounding the settlement agreement into consideration, we are convinced that what Mrs. Hubert received under the settlement agreement is in satisfaction of enforceable rights in decedent's estate. Although the regulations state that the settlement agreement will not *necessarily* be accepted as a bona fide evaluation of such rights, they do not require rejection of such settlement agreement. In this instance we think it is appropriate to recognize the amounts passing to Mrs. Hubert under the settlement agreement as passing from decedent, especially in the absence of any suggestion that the settlement agreement was entered into for post mortem tax planning purposes.

Therefore, we hold that the marital deduction is not limited by the amount Mrs. Hubert would have taken under the 1982 will as amended by the second codicil.

Charitable Deduction

Respondent argues that the charitable deduction also is limited to the lesser of the amount the charity would have received under the 1982 will and codicils or the amount it actually received under the settlement agreement. Petitioner argues that the charitable deduction is equal to the amount the charity actually received provided the settlement was

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not entitled to a charitable deduction for the amount the charity gave up in the settlement, presumably because if the charity never actually received the property before giving it up, it was not a bequest, legacy, devise, or transfer to or for the use of a charitable organization. Consequently, if Mrs. Hubert did not have an enforceable right to all of the amount she received under the settlement, a portion of the residue which was left entirely to either Mrs. Hubert or the charity would be treated as having passed to neither of them.

not collusive. We note that the parties appropriately agree that "the Second Settlement Agreement modified the 1982 Will and three Codicils so that the split interest provisions under I.R.C. section 2055(e) [do] not bar a deduction for the charitable gift". See *Flanagan v. United States*, 810 F.2d 930 (10th Cir. 1987); *First Natl. Bank v. United States*, 727 F.2d 741 (8th Cir. 1984); *Estate of Strock v. United States*, 655 F. Supp. 1334 (W.D. Pa. 1987); *Northern Trust Co. v. United States*, 41 AFTR 2d 78-1523, 78-1 USTC par. 13,229 (N.D. Ill. 1977); Rev. Rul. 89-31, 1989-1 C.B. 277. Therefore, the parties agree that petitioner is entitled to some amount of charitable deduction. Moreover, since the charity will receive less under the settlement agreement than it would have received under the will, respondent and petitioner are in agreement that the settlement agreement controls the amount of the charitable deduction.

Allocation of Expenses

The second issue for decision is whether the marital and charitable deductions must be reduced by expenses allocated to income of the estate.

The 1982 will gave the executors of decedent's estate the power "to charge any expenses against income or principal or apportion the same". The executors allocated $506,989 as funeral and administration expenses to the principal of the estate. All other administration expenses were allocated to income.

Respondent argues that the amount of a marital or charitable deduction must be reduced by the entire amount of administration expenses, whether those expenses are allocated to principal or to income. Respondent cites section 20. 2056(b)-4(a), Estate Tax Regs., and the legislative history of section 2056 as

support for the proposition. In addition, respondent argues that the courts have "uniformly recognized" that administration expenses reduce the marital and charitable deductions regardless of whether those expenses are paid out of income or principal. Respondent contends that both Georgia law and the language of the settlement agreement also mandate such a result. We disagree.

Before considering this issue in detail, it is helpful to consider an overview of the operation of estate accounting and estate taxes. The starting point for determining Federal estate taxes is the date-of-death (or alternate valuation date) value of the property of the estate. Deductions are allowed for various expenses of the estate, as well as for claims against the estate and bequests to the decedent's spouse and to charity. Income earned by the estate has no effect on the estate for Federal estate tax purposes. It is accounted for separately in the estate's probate account and is taxed separately on the estate's Forms 1041.

Executors have been granted significant flexibility in accounting for the estate's administration expenses, both for estate and income tax purposes, and for probate accounting purposes. Congress has granted the executor the option of deducting administration expenses on either the estate return, Form 706, or the fiduciary income tax return, Form 1041. Sec. 642(g). In addition, many States give the decedent the option of authorizing the executor to allocate such expenses to principal or to income at the executor's discretion. If the administration expenses were paid out of principal, they would reduce the amount of such principal received by the beneficiaries and would reduce the marital and charitable deduc-

tions. However, we conclude that the administration expenses that are allocable to income in this case do not change the amount of the estate principal received by the spouse or the charity and do not reduce the marital and charitable deductions. Administration expenses are incurred and accrue during administration and should not be confused with claims against the estate which existed and accrued at the date of death.

Our conclusion that the marital and charitable deductions are not reduced by payment of administration expenses allocated to income does not lead to a double deduction in violation of section 642(g). Section 642(g) prohibits a deduction under section 2053 or 2054 for any administration expenses deducted on the estate's income tax return. However, section 642(g) does not prohibit or reduce deductions under section 2055 or 2056. The deductions under sections 2055 and 2056 are based on the date-of-death value of the property received by the charity and the spouse from the gross estate. The executor's ability to preserve the value of the marital and charitable bequests by allocating administration expenses to income is in no way barred by section 642(g).

The allocation of the expenses in the case before us is governed by Georgia law. Georgia law authorizes allocation of expenses to income rather than principal, if provided in the will. Ga.Code Ann. secs. 53-2-101, 53-15-3 (Michie 1982). The 1982 will authorized such an allocation, and this provision was not affected by the settlement agreement. To the extent the executor exercised its discretion and allocated administration expenses to income, the marital and charitable deductions are not reduced by payment of those expenses.

Respondent argues that section 20.2056(b)-4(a), Estate Tax Regs., controls this question. That section states, in relevant part:

> Marital deduction; valuation of interest passing to surviving spouse.—(a) *In general.* * * * The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. *In determining the value of the interest in property passing to the spouse* account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate. [Emphasis added.]

We do not interpret section 20.2056(b)-4(a), Estate Tax Regs., as mandating a setoff against the marital deduction for administration expenses allocable to income. That section is merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse. The fact that income from property is to be used to pay expenses during the administration of the estate is not necessarily a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate.

On the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. Under section 2056(b)(4) and section 20.2056(b)-4(a), Estate Tax Regs., the value of the interest passing to the spouse and the effect of any encumbrance on that interest shall be determined "as if the amount of a gift to the spouse were being determined." Therefore, we look to the gift tax provisions and consider how they treat the payment of expenses out of the income of a trust that was given to a spouse. Under section 2523(e), in order for a donor to be entitled to a deduction for a gift in trust to his spouse over which the spouse has a general power of appointment, the spouse must be entitled to all of the income from the trust. Under section 25.2523(e)-1(f)(3), Gift Tax Regs., a spouse is considered to receive all of the income from a trust even if "trustees' commissions, and other charges" are paid out of income, provided the spouse is not deprived of substantial beneficial enjoyment. That section is similar to section 20.2056(b)-(5)(f)(3), Estate Tax Regs. In interpreting those sections, respondent has considered the effect of a power "To charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses" on the marital deduction. Respondent concluded that such a power "does not result in the disallowance or *diminution* of the marital deduction." Rev. Rul. 69-56, 1969-1 C.B. 224 (emphasis added). While we recognize that the revenue ruling is not binding precedent, it does present respondent's position on this subject. *Crow v. Commissioner*, 85 T.C. 376, 389 (1985).

In the case before us, the power is essentially the same as the power in the revenue ruling. Moreover, the income used to pay administration expenses is insubstantial compared to the lifetime of income Mrs. Hubert will receive from the property. Therefore, she is not deprived of substantial beneficial enjoyment, and she would be treated, under section 25.2523(e)-1 (f)(3), Gift Tax Regs., as having received all of the income from the trust. If Mrs. Hubert is treated as having received all of the income from the trust, there can be no material limitation on her right to receive income.

We also reject respondent's interpretation of the legislative history of the marital deduction, which states that *claims* against the estate paid out of income increase the residue by purchase, not bequest, and therefore "the value of any such additional part of the residue passing to the surviving spouse can not be included in the amount of the marital deduction." S. Rept. 1013 (Part II), 80th Cong., 2d Sess. (1948), 1948-1 C.B. 331, 335. The Senate report describes the result only if income is used to pay *claims against the estate*; it does not discuss administration expenses at any point. There is a clear distinction between claims against the estate and administration expenses which are allocable to income, and this distinction mandates different treatment of the two. Claims against the estate are, by definition, in existence at the date of death; therefore, by their very nature, claims against the estate relate to corpus and must be charged thereto. By contrast, administration expenses come into existence only after the death of the decedent and may relate to both income and corpus. As a result, administration expenses logically can be charged to either income or corpus. Here they were charged to

income in accordance with the will and Georgia law. Accordingly, the legislative history cited by respondent does not control the treatment of administration expenses in the case before us.

This Court has spoken on this issue in *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987), and *Estate of Street v. Commissioner*, T.C. Memo. 1988-553, affd. in part and revd. in part 974 F.2d 723 (6th Cir.1992). In *Estate of Richardson*, the decedent left to his wife the amount of his residuary estate necessary to maximize all of his estate tax deductions in order to make his estate nontaxable for Federal estate tax purposes. The decedent's executors were given the power to allocate expenses between income and principal. Respondent argued that the marital deduction should be reduced by the amount of interest payable on the estate's Federal estate taxes and State inheritance taxes, even though the executors had allocated the interest to income.

We concluded: "Whether an expenditure on behalf of an estate is chargeable to principal, or the income produced thereby, depends on the law of the State wherein decedent was a resident at the time of his death, or upon the terms of decedent's will." *Estate of Richardson v. Commissioner*, *supra* at 1201. In that case, there were no provisions of State law dictating where the interest should be charged. Therefore, we looked to the language of the will and determined that, based on the decedent's intent to minimize taxes, the executors had the power to charge the interest against income and, thereby, not reduce the marital deduction.

In *Estate of Street*, on similar facts we held that Tennessee law permitted a decedent to grant the power to allocate administration expenses between

income and principal. We held that the marital deduction was not reduced by the amount of the expenses allocated to income.

We note that the fact that the marital bequest in *Estate of Street* was in trust did not affect our reasoning in that case. Respondent argues that the fact of the trust should make a difference, because if Mrs. Hubert is receiving only an income interest and part of the income is used to pay expenses, the value of the interest passing to Mrs. Hubert is reduced. However, respondent ignores the fact that, because Mrs. Hubert has a general power of appointment over one of the trusts and the other trust is a qualified terminable interest trust, Mrs. Hubert is treated as having received the entire value of both trusts, not just the income portions.

On appeal, the Court of Appeals for the Sixth Circuit reversed our holding in *Estate of Street* with regard to administration expenses, concluding that payment of such expenses reduces the marital deduction whether the payment is allocated to income or to principal. However, the court upheld our holding that the payment of interest on estate taxes and inheritance taxes allocated to income does not reduce the marital deduction. *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992), affg. in part, revg. in part and remanding.[4]

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[4] Respondent has now accepted the holding that the payment of interest on estate and inheritance taxes allocated to income does not reduce the marital deduction. Rev. Rul. 93-48, 1993-25 I.R.B. 9. Respondent has specifically limited her change in position to payments of interest and has reaffirmed her position regarding all other administration expenses. As we explain below, we see no valid distinction between interest and other administration expenses.

On the issue of the administration expenses, the Court of Appeals determined that section 20.2056(b)-4(a), Estate Tax Regs., was controlling. The Court of Appeals concluded that the regulation mandates a setoff against the marital deduction for administration expenses paid from income. The court reasoned:

> Income earned by the estate during * * * [the administration] period builds up the marital share. Expenses paid from income during this period have the effect of decreasing the amount of estate property distributable to the spouse. Therefore, the payment of administrative expenses from income must operate to reduce the size of the marital deduction, otherwise the spouse would receive a deduction which exceeded the amount which was actually in the estate, and available for distribution. * * * [*Id.* at 727.]

The court found support for this reasoning in the legislative history of the marital deduction.

The Court of Appeals distinguished administration expenses from interest on estate and inheritance taxes on two grounds. First, citing *Estate of Richardson*, the court stated that the interest on taxes accrues after death, whereas administration expenses "accrue at death." As a result, the court determined that payment of interest on taxes from estate income does not affect the principal of the estate as it existed at the time of decedent's death, but payment of administration expenses from such income "will serve to build up the gross estate." *Id.* at 727. Second, the court noted that section 20.2056(b)-4(a), Estate Tax Regs., specifically mentions administration expenses in its example, but it

does not mention interest on taxes. Therefore, the court held that the regulation was inapplicable to interest on taxes. *Id.* at 729. Thus, the Court of Appeals concluded that payment of administration expenses from income of the estate should reduce the marital deduction, but payment of interest on estate and inheritance taxes from income should not reduce the marital deduction. See also *Burke v. United States*, 994 F.2d 1576 (Fed. Cir. 1993), and *Fisher v. United States*, 28 Fed. Cl. 88 (1993), which rely on the rationale of *Estate of Street* with respect to administration expenses.

Respectfully, we disagree with the reasoning of the Court of Appeals and decline to follow its decision in *Estate of Street*. As stated above, we interpret section 20.2056(b)-4.(a), Estate Tax Regs., to be a valuation provision. Therefore, unlike the Court of Appeals, we find that the regulation does not control the case before us. In addition, as noted previously, we conclude that the legislative history of the marital deduction does not mandate a different conclusion.

Moreover, we take issue with the Court of Appeals' analysis of the effect of income and expenses on the marital share. The court stated that income earned on estate property increases the marital share, and presumably the marital deduction, leading to a deduction greater than the amount distributed if payment of expenses from income does not reduce the marital deduction. However, income earned on estate property is not included in the gross estate. *Alston v. United States*, 349 F.2d 87 (5th Cir. 1965). As a result, under section 2056(a), such income does not lead to an increase in the amount of the marital deduction requiring a corresponding decrease for payment of

administration expenses chargeable against income of the estate.

Finally, we disagree with the Court of Appeals' distinction between interest on estate and inheritance taxes and administration expenses. The fact that section 20.2056(b)-4(a), Estate Tax Regs., explicitly refers to administration expenses but does not mention interest on taxes is not relevant because the reference to administration expenses is "*An* example of a case in which this rule *may* be applied". Sec. 20.2056(b)-4(a), Estate Tax Regs. (emphasis added). Application of the regulation, when appropriate, is clearly not limited to administration expenses. Regardless of the regulation's treatment of administration expenses and interest on taxes, it does not provide a useful distinction between the two.

In addition, administration expenses and interest on taxes cannot be distinguished according to the time at which they accrue. Both accrue after the date of death. Administration expenses, by their very nature, are incurred over the entire period of the estate's administration and can vary significantly from estate to estate. As a result, administration expenses are too uncertain at the date of death to accrue at that time. Our analysis in *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987), therefore applies to administration expenses as well as to interest on taxes, and we will follow our holding in that case.

Both respondent and the Court of Appeals cite *Estate of Roney v. Commissioner*, 33 T.C. 801 (1960), affd. 294 F.2d 774 (5th Cir. 1961), as support for their positions. In *Estate of Roney*, the decedent left the residue of his estate to his wife. The will made no provision as to the source for payment of admini-

stration expenses. The executor deducted the administration expenses on the estate's fiduciary income tax returns and did not reduce the marital deduction on the estate tax return by the amount of those expenses. In that case, we looked to Florida law and determined that the executor was required to pay administration expenses out of the residuary estate. Since the residuary estate does not include income, we determined that the marital deduction should be reduced by the amount of the expenses because the amount of principal received by the spouse was reduced to that extent.

The holding in *Estate of Roney* is not inconsistent with the result we reach in the case before us. We merely held in *Estate of Roney* that when administration expenses are required to be allocated to principal, the marital deduction is reduced by the amount of those expenses. Whether the deduction for the administration expenses is taken on Form 706 or Form 1041 is immaterial and irrelevant. See also *Alston v. United States*, *supra*.

Although *Estate of Wycoff v. Commissioner*, 59 T.C. 617 (1973), affd. 506 F.2d 1144 (10th Cir. 1974), was not cited by either party, we find it appropriate to discuss that case here. In *Estate of Wycoff*, the decedent's will provided:

> all inheritance, estate and transfer taxes due by reason of my death shall be paid out of that portion of my estate which is not included in the Marital Trust to be administered by my Trustee, unless, in the best business judgment and sole discretion of my executor, such taxes could be more prudently paid from any assets in my estate

> without respect to what is or is not included in the Marital Trust * * * [*Id.* at 619.]

Based upon the above election available to the executor, we concluded that the marital trust might be charged with those taxes and that the marital deduction was accordingly reduced. We distinguish that case on its facts.

The executor's choices in *Estate of Wycoff* were between two shares of the estate, the marital trust and the nonmarital trust, both of which were included in the gross estate, and not between principal and income, where only principal would be included in the gross estate and income would be accounted for and taxed separately, as noted above.

We decline to read *Estate of Wycoff* more broadly to make the result depend entirely on the discretion of the executor. We will confine *Estate of Wycoff* to its facts and to the more narrow interpretation which we believe was intended by the Court.

Respondent cites Ga.Code Ann. section 53-2-101 (Michie 1982) as support for the contention that Georgia law requires expenses to be allocated to principal rather than income. However, that section only requires allocation of expenses to the principal if no other provisions are made by the will. Ga. Code Ann. section 53-15-3 (Michie 1982) allows decedents to grant their executors the power to allocate expenses between principal and income. Decedent, in this case, clearly granted such power to his executors.

Finally, we conclude that the settlement agreement did not alter decedent's grant of the power to allocate expenses. The settlement agreement merely set forth a formula for determining the final amounts of both income and principal to be received by Mrs.

Hubert and the charity. That this is the case is demonstrated by the fact that both parties agree the marital portion, as calculated under the settlement agreement, should be reduced by income in order to determine the marital deduction. The fact that the settlement agreement provided for allocation of expenses between the marital and charitable portions does not preclude the executors from allocating those expenses to income rather than principal within those portions pursuant to the 1982 will.

Respondent cites a variety of cases in support of the contention that the marital and charitable deductions must be reduced by expenses. However, none of those cases is on point. They deal with situations in which the will made no provision for the allocation of expenses and, therefore, the statute controlled the allocation. Here, we clearly have a provision in the will which controls the allocation.

We hold that the allocation of petitioner's expenses to income was permitted by Georgia law, and the marital and charitable deductions are not reduced by expenses so allocated.

Imputed Income

The third issue we must decide is whether the marital and charitable portions must be discounted by 7 percent per annum to take into account income deemed to be earned by the residue.

The parties agree that the amounts of the marital and charitable deductions should be based on the date-of-death value of the residue. The parties also agree that the marital and charitable portions as determined by the settlement agreement must be reduced by accumulated income included in those portions to arrive at the date-of-death value of the

principal which will constitute the deductible amounts. The parties disagree about the amount that should be subtracted as income. Petitioner contends that actual income figures should be used. Respondent argues that an imputed figure of 7 percent per annum should be used. We agree with petitioner.

Respondent argues that Georgia law requires us to impute income of 7 percent per annum to the marital and charitable portions and determine the deductions in that manner. Respondent relies on Ga. Code Ann. section 53-2-97 (Michie 1982), which states: "A general legacy usually bears interest after the expiration of 12 months from the death of the testator", and Ga. Code Ann. section 7-4-2 (Michie 1982), which established 7 percent per annum as the legal rate of interest where an interest rate is not established, as support for the imputed income argument. However, those sections are not controlling.

In this case, we are not charged with the task of determining the amounts of income the marital and charitable shares were required to receive. We are charged with determining what amount of the residue went to deductible administration expenses and marital and charitable bequests. In making that determination, we must look to the residue at the date of death. *Jackson v. United States*, 376 U.S. 503, 508 (1964).

At the time of decedent's death, the amount of the residue was a definitely determinable amount. Under the settlement agreement, that amount was divided among the marital and charitable portions, which included income to the date of settlement, and the administration expenses. Despite the agreement's complex language and respondent's contention that

the agreement is much more complex, the result is, in fact, very simple. The entire residue is divided among three deductible portions, making the entire residue deductible no matter how much income was or should have been earned later.

The value of the corpus at the date of death is the value used in determining the deductions. Any use of income figures is merely to determine the amount of income allocated to each of the portions; for that determination, it is appropriate to use actual income figures. For our purposes, however, that determination is irrelevant, since the corpus allocated to each of the portions is deductible.

We hold that the marital and charitable portions should not be discounted 7 percent per annum for income deemed to be earned by the residue in order to arrive at the marital and charitable deductions. Date-of-death values should be used. If the parties need income figures for purposes of the Rule 155 computation, actual income figures should be used.

Decision will be entered under Rule 155.

Reviewed by the Court.

PARKER, SHIELDS, COHEN, SWIFT, JACOBS, GERBER, WRIGHT, PARR, WELLS, RUWE, WHALEN, COLVIN, CHIECHI, and LARO, *JJ.*, agree with the majority opinion.

HAMBLEN, *C.J.*, did not participate in the consideration of this opinion.

HALPERN, *J.*, concurring in part and dissenting in part:

I. *Limitations on Deductions Based on the 1982 Will*

A. *Settlement Agreement: Marital Deduction*

Mrs. Hubert challenged the will of her late husband on the ground that it was executed under undue influence in favor of certain charitable beneficiaries. Pursuant to the Second and Final Settlement Agreement (the settlement agreement), to which respondent was not a party, Mrs. Hubert received from the estate of Mr. Hubert (the estate) an amount in excess of what she would have received under her late husband's last will. The majority holds that the marital deduction is determined based on the amount received by Mrs. Hubert under the settlement agreement. Majority op. p. 12. Necessarily, the majority has found that Mr. Hubert's last will (the 1982 will), or at least the second codicil thereto (which reduced the amount Mrs. Hubert was to receive), is invalid, as having been procured by undue influence. See Ga. Code Ann. sec. 53-2-6 (Michie 1982) (undue influence invalidates a will). I cannot agree with that finding because I believe that it is unsupported by the evidence.

1. *Property Must Pass from the Decedent*

Section 2056 permits a marital deduction only with respect to property that "passes or has passed *from the decedent* to his surviving spouse" (emphasis added). Accordingly, if property passes from the decedent to *other* than his surviving spouse, no marital deduction is allowable, even if the property is promptly relinquished to the surviving spouse. E.g.,

Estate of Suzuki v. Commissioner, T.C. Memo. 1991-624. Of course, a dispute may arise as to whether, or to what extent, property *does* pass from the decedent to a surviving spouse. An agreement may be reached whereby such claims are settled other than by decision of a court. As a rule, the Commissioner is not a party to such agreements. In such case, the Commissioner may or may not accept the agreed allocation to the surviving spouse as reflective of what actually passed to her from the decedent. At one time, this Court took the position that, so long as the settlement agreement was "made in good faith as a result of arm's-length bargaining", property received by the surviving spouse *necessarily* had "passed from the decedent" and thus might qualify for the marital deduction. *Estate of Barrett v. Commissioner*, 22 T.C. 606, 611 (1954). That view, however, has been repudiated by the Supreme Court, see *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), and, indeed, today, this Court *appears* to abandon it. Majority op. p. 9.

2. *The Inquiry at Hand*

Correctly, I believe, the majority characterizes the nature of our inquiry as follows: "In deciding whether the surviving spouse has enforceable rights in decedent's estate, courts must look behind any settlement agreement to ensure that the claim on which it is based is valid." Majority op. p. 9. Also, like the majority, I would not ignore the settlement agreement. Indeed, the regulations contemplate that a settlement agreement *may* provide a bona fide evaluation of the rights of the spouse in the decedent's estate. See sec. 20.2056(e)-2(d)(2), Estate Tax Regs. Based on the majority's analysis, however, it is

difficult for me to see how the majority has not simply accepted the bona fides of the settlement agreement as determinative of (1) the invalidity of Mr. Hubert's will (or, at least, the second codicil thereto) and, consequently (2) the validity of Mrs. Hubert's claim. If the majority has done that, then it has merely repackaged old (and bad) wine into new bottles, see *Estate of Barrett v. Commissioner*, *supra*, and not undertaken the full investigation it has promised.

3. *Burden of Proof*

Petitioner has the burden of proving that Mrs. Hubert was entitled, under decedent's last valid will, to the entire amount received under the settlement agreement. Rule 142(a); cf. *Estate of Rowan v. Commissioner*, 54 T.C. 633, 639 (1970) (if, pursuant to *Commissioner v. Estate of Bosch*, *supra*, we must determine property rights under State law, under normal rule assigning burden of proof, petitioner has burden of proving facts that support his assignment of error). To carry that burden, petitioner must prove its assertion that the second codicil to the 1982 will (or perhaps the 1982 will itself) is the product of undue influence and therefore invalid.

4. *The Settlement Agreement*

The only direct evidence relied on by the majority in reaching its conclusion that petitioner has carried its burden is the settlement agreement itself. The settlement agreement, however, does not even *assert* that any of decedent's wills or codicils is invalid on account of undue influence, and, thus, by its language alone, cannot constitute evidence in support of that

proposition.[5] Nevertheless, accepting for the sake of argument that Mrs. Hubert's claim of undue influence is not without *some* merit, the settlement agreement *might* constitute persuasive evidence of the validity of that claim (i.e., that the will or codicil *was* obtained by undue influence) *if* the amount received pursuant to the settlement agreement approximated what Mrs. Hubert would have received had she prevailed on her claim in the absence of a compromise. In other words, we might equate the *strength* of her claim with the *degree* of her financial success.

5. *Mrs. Hubert's Financial Success*

On the whole, the majority gives us scant information to judge the degree of Mrs. Hubert's financial success. We know only that, pursuant to the settlement agreement, she received in value (1) more than half of what she would have received if she had succeeded in having the second codicil declared invalid and (2) substantially all of what she would have received if she had succeeded in having the 1982 will itself declared invalid. Majority op. p. 10. We are provided with no numbers or any finding as to whether the will itself or only a codicil is invalid. The majority does state that the settlement agreement amended the 1982 will and codicils by deleting that provision in the will that disposed of the residuary estate, and all related codicil provisions. Majority op. p. 5. Such evidence would thus suggest that an

[5] I am by no means convinced that, if the settlement agreement did make an assertion in that regard (as it might have if such agreement resolved other disputes as well and the parties thereto agreed as to who purportedly prevailed on each issue), such assertion would be credible evidence. That question, however, need not be resolved today.

assumption of the parties to the settlement agreement was that the 1982 will otherwise remained intact.[6] From the record, we also learn (although the majority does not tell us) that Mrs. Hubert's interest in the residue of the estate under the 1982 will and codicils had a value equal to only 48 percent of the value of the residue and that the value of what she received under the settlement agreement had a value equal to approximately 50 percent of that residue. Had she succeeded in having the second codicil declared invalid, she would have restored her power of appointment over the residue and thus would have enjoyed 100 percent of its value. It is thus true, as the majority claims, that, under the settlement agreement, by obtaining approximately 50 percent of the residue, she received in value more than half of what she would have received on her primary claim (that the second codicil was invalid). Nevertheless, that is *not* the important comparison. The *important* comparison is between what she received and what she would have received had she *not* made any claim in the first place. That comparison is between 48 percent of the residue (what she would have received under the second codicil) and approximately 50 percent (what she did receive). Thus, *as a measure of her success*, she received *approximately 4 percent* of what she claimed. That is *not* persuasive evidence that her claim was strong.

[6] That also would seem to be the assumption made by the majority. In a companion case to this case, *Estate of Hubert v. Commissioner*, T.C. Memo. 1993-482, Judge Clapp, the author of the majority opinion here, addresses a charitable bequest passing pursuant to the 1982 will (and not affected by the settlement agreement). The 1982 will is quoted verbatim as giving rise to the bequest. The 1977 will is not mentioned.

6. *Other Evidence*

Putting aside Mrs. Hubert's apparent lack of financial success, we are left with a finding by the majority based on the bona fides of the transaction:

> this was a settlement among adverse parties with significant interests to protect in the litigation, including the Georgia attorney general and the Georgia revenue commissioner, whose right to participate in the litigation was litigated all the way to the Supreme Court of Georgia. The settlement agreement also was approved by the Superior Court of Cobb County. Under Georgia law a settlement agreement sustaining a will challenge can be approved by the Superior Court only "after a hearing * * * at which the judge finds * * * that the caveat is meritorious." * * * [Majority op. pp. 10-11.]

The regulations establish a presumption that a transfer to a surviving spouse is in recognition of enforceable rights in the decedent's estate if it is pursuant to a decision by a local court upon the merits in an adversary proceeding following a genuine and active contest. Sec. 20.2056(e)-2(d), Estate Tax Regs. There is *no* indication that such a proceeding occurred here, and the majority fails to explain what weight (or meaning) it gives to the Superior Court's finding that the settlement agreement was "meritorious". It is unclear whether the majority takes the Superior Court's finding to mean anything more than that, *if proven*, Mrs. Hubert's claim would entitle her to the relief prayed for. If so, then that does not constitute any evaluation of the *strength* of her claim, or convincing evidence that the 1982 will (or second codicil) was invalid.

Likewise, what are we to make of the majority's reliance on the "adverse", "significant" interests of the parties to the settlement agreement, without the majority, *at the same time*, taking into account the *degree* of Mrs. Hubert's success? In *Estate of Barrett v. Commissioner*, 22 T.C. 606, 611 (1954), we dealt with the settlement of a surviving spouse's claim against the estate and said:

> Our finding as a fact that * * * [the surviving spouse's] claim was a valid one made in good faith and settled as the result of arm's-length negotiations is enough to qualify it as a bona fide claim within the purview of the regulations [the predecessor to sec. 20.2056(e)-2(d)(2), Estate Tax Regs.].

If we disregard the *degree* of Mrs. Hubert's success, are we not right back to our position in *Barrett* (looking to the bona fides of the agreement), which today we seem to repudiate?

7. *Commissioner v. Estate of Bosch*

The lesson of *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), is that, respondent, having been absent from the State court proceeding that established rights to the decedent's property, is entitled to her day in Federal court, unless she could not there prevail. Here, we have a question of fact, for which petitioner bears the burden of proof. The evidence in this case, as analyzed by the majority, does not convince me that Mr. Hubert's 1982 will (or at least the second codicil thereto) was invalid. Indeed, based on the lack of Mrs. Hubert's financial success, I would find to the contrary. For that reason, I cannot agree with the majority's holding

that the marital deduction is determined based on all of what Mrs. Hubert received under the settlement agreement, and would limit the deduction to what she received under Mr. Hubert's 1982 will and the codicils thereto.

B. *Settlement Agreement: Charitable Deduction*

Apparently, respondent has conceded that, whether or not we find decedent's last will (or the second codicil thereto) to be invalid, the estate is entitled to a charitable deduction equal to the lesser of the amount the charity would have received under the 1982 will or the amount it actually received under the settlement agreement. Majority op. pp. 12-13. We thus need not determine whether the estate's charitable deduction is limited to the amount that would have been received under decedent's last valid will, as properly interpreted under State law.[7] Assuming that the majority

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[7] Compare *Estate of Warren v. Commissioner*, 93 T.C. 694, 726-727 (1989) (where (1) acknowledging the application of *Commissioner v. Estate of Bosch*, 387 U.S. 456 (1967), to our evaluation of an "agreed final judgment" settling the rights of a charitable beneficiary to a portion of the residue of the decedent's estate (2) we rejected the agreed judgment, determining that it incorrectly applied State law), revd. and remanded 981 F.2d 776 (5th Cir.1993) with *Estate of Warren v. Commissioner*, 981 F.2d 776, 782 (5th Cir.1993) (where the Court of Appeals for the Fifth Circuit (1) dismissed *Estate of Bosch* as inapplicable and (2) declined to apply the so-called enforceable rights doctrine to the charitable deduction: "But where the settlement is a *bona fide* resolution of a truly adversarial dispute as to rights of the charity under a will of the decedent, then the forgoing requirement [that what is received by the charity must be received from the decedent and not merely from the beneficiaries of the estate] would appear to be satisfied, for in such a case what the charity receives it receives *as a result and by virtue of* the provisions

here has found that the second codicil to decedent's 1982 will, but not the will itself, is invalid, the amount passing to the charity pursuant to the settlement agreement may well exceed the value of what it was entitled to pursuant to such will (i.e., the amount of the residue not appointed by Mrs. Hubert).

Respondent has stipulated that "the Second Settlement Agreement modified the 1982 Will and three Codicils so that the split interest provisions under I.R.C. section 2055(e) [do] not bar a deduction for the charitable gift". Although I am by no means convinced that a settlement agreement can transform a non-qualifying interest into a qualifying interest, I would simply accept respondent's concession in this case and leave that question for another day.

II. *Allocation of Expenses*

The second issue addressed by the majority is whether the marital and charitable deductions must be reduced by expenses allocated to income of the estate. The majority holds that such deductions need not be so reduced. Majority op. p. 27. With regard to the marital deduction, the majority considers section 2056(b)(4) and section 20.2056(b)-4(a), Estate Tax Regs., and finds that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. Majority op. p. 17. In his separate opinion, Judge Beghe calculates the relevant amounts of income and administration expenses. Like Judge Beghe, I cannot conclude that what the majority characterizes as the

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made for it in the decedent's will, whether or not it receives precisely what it would be entitled to if no settlement had been made."), revg. and remanding 93 T.C. 694 (1989).

"trustee's discretion" is an immaterial limitation on the surviving spouse's right to receive income from property passing to her, which is to be disregarded in determining the value of such property. See sec. 20.2056(b)-4(a), Estate Tax Regs. I write separately from Judge Beghe, however, because I believe that the majority's error runs much deeper than failing to recognize a material limitation on the right to receive income in this case. The majority adopts an approach that (1) appears inconsistent with section 20.2056(b)-4(a), Estate Tax Regs., (2) is premised upon a misconception concerning the consequence of probate accounting allocations to income and principal in valuing the gross estate and interests therein, and (3) is inconsistent with precedent of this Court.

A. *Inconsistency With Section 20.2056(b)-4(a), Estate Tax Regs.*

Section 20.2056(b)-4(a), Estate Tax Regs., provides that "In determining the value of the interest in property passing to the spouse *account must be taken of the effect of any material limitations upon her right to income from the property.*" (emphasis added). The majority resists that directive, however, and adopts a theory under which it appears that *no* limitation on a surviving spouse's right to income would be taken into account, whether material or immaterial. Under the majority's approach, the allocation, for probate accounting purposes, of estate administrative expenses between income and principal is critical. Expenses allocated to principal are in all events taken into account in valuing the marital deduction:

> If the administration expenses were paid out of principal, they would reduce the amount of such principal received by the beneficiaries and would reduce the marital and charitable deductions. * * * [Majority op. p. 15.]

Income earned by the estate, in the majority's view:

> has *no effect* on the estate for Federal estate tax purposes. It is accounted for separately in the estate's probate account and is taxed separately on the estate's Forms 1041. * * * [Majority op. p. 14; emphasis added.]

Such income (in the majority's view) having *no effect* on the estate, it is difficult to see how the *materiality* of any charge against it for administration expenses matters in the least. Indeed, the majority states:

> income earned on estate property is not included in the gross estate. * * * As a result, under section 2056(a), such income does not lead to an increase in the amount of the marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate. [Majority op. p. 23.]

In the majority's view, apparently, probate income simply is irrelevant to the marital deduction. The majority appears to believe that probate income neither increases nor decreases the surviving spouse's share of property passing from the deceased.

Thus, the majority's rationale is not dependent on the burden of administrative expenses being an immaterial limitation on the surviving spouse's right to income from the property. See sec. 20.2056(b)-4(a), Estate Tax Regs. It is enough for the majority that the expenses are paid from *income* rather than *principal*. See majority op. p. 15. The majority cites

two cases in support of its broad dichotomy between principal and income: *Estate of Street v. Commissioner*, T.C. Memo. 1988-553, affd. in part and revd. in part 974 F.2d 723 (6th Cir.1992), and *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987). Neither case, however, explains how we might be justified in declining to take into account material limitations on a surviving spouses's right to income, as section 20.2056(b)-4(a), Estate Tax Regs., directs. Indeed, neither case contains any meaningful discussion of that regulation and *Estate of Street* fails even to mention it. Accordingly, I believe that the theory adopted by the majority is inconsistent with section 20.2056(b)-4(a), Estate Tax Regs., and, therefore, invalid.

B. *The Majority's Misconception About Probate Accounting Allocations to Income and Principal*

In distinguishing between charges to probate-accounting principal and income,[8] the majority relies upon the assumption that, although principal is included in the gross estate, income is not. ("[I]ncome earned on estate property is not included in the gross estate." Majority op. p. 23.) That distinction, however, simply will not hold. The gross estate includes, generally, the decedent's interest in "all property, real or personal, tangible or intangible, wherever situated." Secs. 2031, 2033. Such (included) property interests are valued as of a particular time:

[8] Principal and income are probate-accounting concepts that sometimes are necessary to determine, *for probate accounting purposes*, the allocation of post mortem charges or changes in value among temporal interests carved out of probate property (e.g., a life estate and remainder). That distinction is not necessarily significant for a given tax purpose.

either the date of decedent's death or the alternate valuation date (hereinafter the appropriate valuation date). Secs. 2031 and 2032. Nothing in that scheme supports the proposition that either principal or income are includable in the gross estate to the exclusion of the other. Rather, because the value of the gross estate consists of decedent's interest in both principal and income, both of those components are included in the gross estate.[9] Only by considering principal and income as a *unit*, and only by discounting them together to their present value as of the appropriate valuation date, can the gross estate properly be valued. The allocation between the two is not relevant to that determination.

Thus, consider a zero coupon bond included in the gross estate at a value of $1,000. One year after the appropriate valuation date, the bond is sold for $1,100. Proceeds are allocated $1,000 to principal and $100 to income. Implicitly, the rate of return to the estate with regard to the bond is 10 percent. Thus, the appropriate-valuation-date present values of such principal and income are, approximately, $910 and $90, respectively, or $1,000, together. If the bond were sold 2 years after the appropriate valuation date for $1,210, with $1,000 allocated to principal and $210 to income, the appropriate-valuation-date present values of principal and income would be, approximately, $826 and $174, respectively, or, again, $1,000, together. Only if the bond is sold immediately on the

[9] It is true, of course, that income *actually earned* on such property during the period of estate administration is not included in the gross estate. The gross estate, however, *does* include the *discounted* value of post mortem income *expected to be earned* during estate administration.

appropriate valuation date for its value of $1,000 would the allocation to principal of $1,000 have an appropriate-valuation-date present value of the same amount. Comparing principal and interest, on the one hand, to the value of assets included in the gross estate, on the other, presents somewhat of an apples and oranges problem. Unless adjustments are made for differences in the times of measurement, the comparison can be misleading.

Accordingly, I believe the majority is undone by its view that income earned on estate property is not included in the gross estate. Once it is accepted that income earned on estate property (as anticipated at the appropriate valuation date) *is* included in the gross estate, the next question is whether, but for the use of such income to pay administration expenses, it would be received by the surviving spouse or charitable beneficiary. If the answer is yes, then it follows easily that, when such income is used for administration expenses, rather than received by the surviving spouse or charitable beneficiary, the value of the interest passing from the decedent to the surviving spouse or charitable beneficiary is decreased. Thus, for example, if the residue of the probate estate is bequeathed to a qualifying charity, and administration expenses properly are paid from such residue, then the value of the interest passing from the decedent to the charitable beneficiary is less than the estate-tax value of the residue, regardless of whether, *for probate accounting purposes*, such expenses properly are allocable to income or principal with regard to the assets of the residue.

Two Courts of Appeals have taken precisely that position. The Court of Appeals for the Federal Circuit recently has concluded that administration

expenses charged to the residue of the probate estate reduce the estate-tax value of that residue for purposes of the charitable deduction. *Burke v. United States*, 994 F.2d 1576, 1581 (Fed. Cir. 1993) ("In sum, when a decedent dies, a finite amount known as the gross estate is legally created. Any deductions for expenses incurred in administering the estate are theoretically derived from this amount and, regardless of the actual source of payment, must be accounted for within the gross estate."). The Court of Appeals for the Fifth Circuit has expressed similar sentiments:

> No amount of legalistic legerdemain can produce from * * * [the cited] cases "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * *" as argued by the executors.

Alston v. United States, 349 F.2d 87, 89 (5th Cir. 1965); cf. *Estate of Horne v. Commissioner*, 91 T.C. 100, 109 (1988) (amount of residue qualifying for estate-tax charitable deduction must be reduced by executor's commissions chargeable under State law to principal but actually paid from post mortem income).

For the foregoing reasons, I think the majority errs in assuming that the gross estate does not include income earned on estate property during estate administration and therefore errs, on facts such as here existing, in failing to reduce the marital and charitable deductions where the surviving spouse or charitable beneficiary does not receive such income from the estate.

C. *Inconsistency With Precedent of This Court*

In my view, the majority gives insufficient attention to *Estate of Wycoff v. Commissioner*, 59 T.C. 617 (1973), which, until overruled, should be controlling herein. In *Estate of Wycoff*, the executor had the discretion to pay certain expenses from either the marital trust or the nonmarital trust. We held that the executor's *discretion* to invade the marital trust reduced the value of the marital deduction. Our reasoning, though debatable, was quite clear: (1) The interest passing to the surviving spouse is measured at the appropriate valuation date (later events are irrelevant), and (2) the possibility (existing at that time) that the executor would choose to invade the marital, rather than nonmarital, trust reduced the value of the interest passing at such time to the surviving spouse. *Id.* at 622-623.

> The *Mappes* case [318 F.2d 508, 510-511 (10th Cir. 1963)] makes it clear that for purposes of the marital deduction whether an interest passing to the surviving spouse qualifies is a question which must be determined at the time of decedent's death. It is not a determination affected by later events which may or may not happen. The case of *Estate of Albert L. Rice* [41 T.C. 344 (1963), modified sub nom. *Boston Safe Deposit and Trust Co. v. Commissioner*, 345 F.2d 625 (1st Cir. 1965)], *supra*, stands for the application of this proposition to the valuation area. In that case a marital deduction was limited to the interest passing to the surviving spouse reduced by its apportioned share of Federal estate and State inheritance taxes. This was so in spite of the fact that the trustee exercised his discretionary power

> and paid all the taxes from the assets of the nonmarital trust. [*Id.* at 623.]

The majority dismisses *Estate of Wycoff* because the executor's choice there was between marital and nonmarital trusts, whereas here the choice was between principal and income. Majority op. p. 26. In so doing, the majority declines "to read *Estate of Wycoff* more broadly to make the result depend entirely on the discretion of the executor" and confines *Estate of Wycoff* "to its facts and to the more narrow interpretation which [it believes] was intended by the Court." Majority op. p. 26. The majority fails, however, to specify any interpretation of *Estate of Wycoff* that would be consistent with the result reached today and, indeed, I believe there is none. Although I am by no means convinced that *Estate of Wycoff* reaches the proper result, I think the majority is remiss in failing to follow *Estate of Wycoff*, which it declines to overrule.

III. *Discounting of Marital and Charitable Portions*

The third issue is whether the marital and charitable portions must be discounted by 7 percent per annum to take into account income deemed to be earned by the residuary under Georgia law. See Ga. Code Ann. sec. 53-2-97 (Michie 1982). The majority observes, and the parties agree, that the marital and charitable deductions should be based on the date-of-death value of the residuary. Majority op. p. 28-29. The majority continues to observe that the *actual* date-of-death value of the residuary is known (or at least "definitely determinable"). Majority op. p. 29. Accordingly, I agree with the majority that no adjustment is necessary to arrive at that figure.

BEGHE, *J.*, agrees with this opinion.

BEGHE, *J.*, concurring in part and dissenting in part:

Having joined Judge Halpern's concurring and dissenting opinion, I also write separately to emphasize my dissent from various aspects of the Court's holding that the payments of estate administration expenses from income do not reduce the marital and charitable deductions allowable for Federal estate tax purposes. In the case at hand, as in other recent estate tax cases in which administration expenses were claimed as income tax deductions, the Court's opinion has the effect of abetting a post mortem estate planning blunder or maneuver. See *Estate of Street v. Commissioner*, T.C. Memo. 1988-553, affd. in part and revd. in part 974 F.2d 723 (6th Cir. 1992); see also *Estate of McInnes v. Commissioner*, T.C. Memo. 1992-558; *Estate of Young v. Commissioner*, T.C. Memo. 1992-551.

The majority interpret section 20.2056(b)-4(a), Estate Tax Regs., as not requiring a setoff against the marital deduction for administration expenses paid from income, but as being "merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse." Majority op. p. 17. The majority opinion goes on to say:

> The fact that income from property is to be used to pay expenses during the administration of the estate is not necessarily a material limitation [within the meaning of section 20.2056(b)-4(a), Estate Tax Regs.] on the right to receive income that would have a significant effect on the date-

> of-death value of the property of the estate [Majority op. p. 17.]

and that

> Moreover, the income used to pay administration expenses is insubstantial compared to the lifetime of income Mrs. Hubert will receive from the property. * * * [Majority op. p. 18.]

In so saying, the majority opinion falls short in a variety of ways: (1) It creates the impression that charging estate administration expenses against income can never have a significant effect on the values of the income interests of the surviving spouse and charitable beneficiaries of the estate; (2) it strengthens that impression by providing no sense of the substantial amounts that have already been charged against and paid from the income rights of the marital and charitable residuary interests;[10] (3) it opens the barn door to substantial but unknown additional amounts being so charged and paid in the future, without regard to the fact that these additional charges would further reduce the values of the residuary interests of the surviving spouse and

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[10] Although, as the majority observe, majority op. p. 15, the payment of administration expenses from income does not reduce the estate principal received by or set aside for the surviving spouse and the charities, the payment of the expenses from income necessarily reduces the income to which those residuary legatees would otherwise be entitled. As a result, the values of the property interests actually received by the residuary legatees have been reduced.

the charities;[11] and (4) it does not separately address the effect on the estate tax charitable deduction of charging the administration expenses to the income of the residuary estate; in this last respect the majority have decided not to apply the decisions of the Court of Appeals for the Federal Circuit in *Burke v. United States*, 994 F.2d 1576 (Fed. Cir. 1993) and the Court of Appeals for the Fifth Circuit in *Alston v. United States*, 349 F.2d 87 (5th Cir. 1965), and to depart from the approach we took in *Estate of Warren v. Commissioner*, 93 T.C. 694 (1989), revd. on other grounds and remanded 981 F.2d 776 (5th Cir. 1993), and *Estate of Horne v. Commissioner*, 91 T.C. 100 (1988).

The majority's argument with respect to the marital deduction, that Mrs. Hubert must be considered to have received the entire value of both marital trusts, because she has a general power of appointment over one, and the other is a QTIP trust, see majority op. p. 21, is also misplaced. This argument glides over the requirement that the surviving spouse, irrespective of whether she has a general power of appointment or the QTIP provisions are otherwise satisfied, must have the unqualified right to receive the entire income of the property interest with respect to which the marital deduction is being claimed, if the full marital deduction for the

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[11] In this regard, the executors have candidly expressed the intention, if their contentions on this issue should be upheld, to charge all subsequent estate administration expenses, including the legal fees of this proceeding, to the income of the residuary interests, and also to claim these expenses as deductions for Federal income tax purposes. As a result, the values of the residuary interests will be further reduced in some currently unknown but probably substantial amounts.

value of that property interest is to be allowed. *Northeastern Pa. Natl. Bank & Trust Co. v. United States*, 387 U.S. 213 (1967); H. Rept. 1337, 83d Cong., 2d Sess. 92 (1954); S. Rept. 1622, 83d Cong., 2d Sess. 125 (1954). If and to the extent that right to income is reduced, the allowable marital deduction is cut back, cf. *Estate of Alexander v. Commissioner*, 82 T.C. 34 (1984), affd. without published opinion 760 F.2d 264 (4th Cir. 1985), if not completely disallowed, see sec. 20.2056(b)-5(b), Estate Tax Regs.; cf. Energy Policy Act of 1992, Pub. L. 102-486, sec. 1941, 106 Stat. 3036; H. Conf. Rept. 102-1018 at 432 (1992). See generally Kasner, "Recent Legislation and Pecuniary Marital Deduction Bequests", Tax Notes 1094 (May 24, 1993).

Although the stipulated record in this case is not as clear as it should be, the actual amounts in issue belie the majority's conclusion that the residuary interests have not already been subjected to a "material limitation" within the meaning of section 20.2056(b)-4(a), Estate Tax Regs.:

Gross estate	$ 30,254,219
Marital share	13,353,572
Charitable share	12,870,864
Residuary estate	26,224,436
Income distributed to Mrs. Hubert through 5/31/90	1,219,603
Income distributed to Mrs. Hubert through 5/31/90 from other interests qualifying for marital dedn.	699,376
	1,918,979
Income used to pay admin. expenses through 5/31/90 and deducted for income tax purposes	1,458,445
Post-settlement agreement income through 9/26/91	1,173,171
Post-settlement admin. expenses charged to income and deducted for income tax purposes	548,414

It thus appears that, for the first 5 years' administration of the estate, the income interests of the surviving spouse and the charities have been substantially burdened and materially limited by the payment of estate administration expenses, which have been both charged to income and deducted for Federal income tax purposes. These administration expenses have been substantially in excess of the "trustee's commissions, and other charges", majority

op. p. 18, of administering an estate or trust in the ordinary course that can be paid out of income without depriving the surviving spouse beneficiary of the required substantial beneficial enjoyment within the meaning of section 25.2523(e)-1(f)(3), Gift Tax Regs. See also sec. 20.2056(b)-5(f)(3), Estate Tax Regs. During this 5-year period, the estate generated gross income of no less than $4.5 million, of which approximately $2 million was used to pay administration expenses that were charged to income and deducted for Federal income tax purposes. If it be assumed that these expenses were paid ratably over the 5-year period following decedent's death, the equivalent of a 5-year annuity of approximately $400,000 has been charged against the income interests of the surviving spouse and the charities. Such an annuity would have had a date-of-death present value of $1,511,352 (using the 10-percent table B of sec. 20.2031-7(f), Estate Tax Regs., applicable to estates of decedents dying after November 30, 1983, and prior to May 1, 1989), and the marital and charitable deductions should be reduced accordingly.

Rather than reducing the widow's marital share and the charitable share dollar for dollar, or approximately $2 million, as argued by respondent,[12] based on the amounts actually charged against income, I would

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[12] Under the terms of the settlement agreement, the division of the residuary between the marital and charitable shares was 52 percent and 48 percent, respectively. The record does not indicate the amounts of income distributed or held for distribution to the charitable beneficiaries. In any event, it appears that the income used to pay estate administration expenses during the first 5 years of the estate's administration was no less than 20 percent of the estate's income during this period, a not insignificant amount.

apply the majority's interpretation of section 20.2056(b)-4(a), Estate Tax Regs., as a valuation provision to reduce the aggregate marital and charitable deductions by the date-of-death present value of the annuity charged against the residuary interests in the estate.[13] Assuming that the expenses were charged against both the marital and charitable residuary interests, the marital and charitable deductions should be reduced in the same proportions that they bear to the total residuary estate. The same general approach should be used to determine the estate tax effects of estate administration expenses subsequently incurred and paid that petitioner actually charges to income and claims as income tax deductions.

In dealing with this problem, will drafters, estate administrators, and the courts should be under no illusions about the potential benefits and amounts at risk in claiming estate administration expenses as income tax deductions. Under the majority's approach, there is a substantial tax benefit in claiming income tax deductions for expenses paid from income that would otherwise accrue to the marital and charitable residuary shares. The benefit is that the

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[13] I am aware that this approach is arguably contrary to the view, represented by such cases as *Estate of Wycoff v. Commissioner*, 59 T.C. 617, 621-623 (1973), affd. 506 F.2d 1144 (10th Cir. 1974), that the reduction in value must be determined as of the date of death by reference to what the executors have the power to do under State law. Because application of this view could have draconian results that would even more seriously encroach upon the marital and charitable shares than respondent's determination in this case, I prefer the approach espoused in the text, which has both "wait and see" and nunc pro tunc aspects.

estate tax deductions for the value of the principal amounts passing to or for the benefit of the surviving spouse and the charitable beneficiaries are not reduced by the expenses. Yet those expenses are also allowed as income tax deductions, in effect creating a double deduction that "would violate the spirit, if not the literal language, of section 642(g)." Gans, "Will Administration Expenses Charged to Income Reduce the Marital Deduction?", 71 J. Taxn. 90, 91 (1989). However, the benefits of the double deduction will be exceeded, if the maneuver is held to be unsuccessful—as it should be—by the detriment of the "hall of mirrors" effect under which the amount of any death taxes chargeable against a marital bequest is itself subject to the Federal estate tax. As a result, the estate tax deficiency will chew into and reduce the allowable marital deduction in amounts that will disproportionately exceed, with exponentially incremental effect, the initial amount of the disallowed marital deduction. See 5 Bittker & Lokken, Federal Taxation of Income, Estates and Gifts 129-77 (2d ed.1993). The same is true of the charitable residuary bequest and the estate tax charitable deduction. *Id.* at 130-30 through 130-33.

The Tax Court stands virtually alone on this issue. The preponderance of academic and professional opinion has been that *Estate of Street v. Commissioner*, T.C. Memo. 1988-553, was incorrectly decided. See Gans, "Will Administration Expenses Charged to Income Reduce the Marital Deduction?", 71 J. Taxn. 90 (1989); Covey, "Administration Expenses and Interest Charged to Income", U. of Miami Estate Planning Conference par. 1701.3 (1990); United States Trust Company of New York, "Operation of Credit Shelter Formula Provision", Practical

Drafting 1685-1688 (Apr. 1989); United States Trust Company of New York, "Operation of Credit Shelter-Marital Deduction Formula Provisions", Practical Drafting 3055-3062 (Jan. 1993). But see Kasner, "Marital Deduction Bequests: The Impact of Estate Debts and Expenses", Tax Notes 229 (Apr. 12, 1993).

Because the result in *Estate of Street v. Commissioner*, *supra*, seemed too good to be true, the commentators cautioned practitioners not to rely on the Tax Court's decision. Practitioners were advised to insulate the marital bequest from the effect of *Estate of Street's* reversal or repudiation by allocating the expenses to the unified credit shelter bequest, with the possibility of a renunciation by the surviving spouse if our decision in *Estate of Street* should be upheld. Such cautionary measures would have been well taken, in view of the reversal of our decision in *Estate of Street* by the Court of Appeals for the Sixth Circuit in 974 F.2d 723 (6th Cir. 1992), its repudiation by the Court of Federal Claims in *Fisher v. United States*, 28 Fed. Cl. 88 (1993), and the recent confirmation by the Court of Appeals for the Federal Circuit in *Burke v. United States*, 994 F.2d 1576 (Fed. Cir. 1993), that there must be a similar reduction of the estate tax deduction for a charitable residuary bequest when estate administration expenses are paid and deducted from income.

The expenses paid and to be paid from income in this case are so large that such measures would have been and are unavailing to petitioner. Only our refusal to change course stands between respondent's proposed adjustments and the marital and charitable residuary shares. We should stop swimming against the tide and go with the flow.

HALPERN, *J.*, agrees with this opinion.

No. 95-1402

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1995

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA) N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

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41PP

QUESTION PRESENTED

Whether, in calculating the taxable estate for purposes of the federal estate tax, payment of post-death estate administration expenses out of post-death estate income reduces the marital and charitable deductions for date-of-death value bequests which are allowed by the Internal Revenue Code, 26 U.S.C. §§ 2055 and 2056, when such expenses are permitted by state law and the testamentary documents to be paid out of post-death income of the estate.

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APPENDIX

Appendix A — Stipulation of Facts 1a

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eleventh Circuit (Pet. App. 1a-23a) is reported at 63 F.3d 1083 (1995). The opinion of the court of appeals on rehearing (Pet. App. 24a-25a) is not reported. The opinion of the United States Tax Court (Pet. App. 26a-79a) is reported at 101 T.C. 314 (1993).

STATEMENT OF JURISDICTION

The judgment of the court of appeals was entered on September 12, 1995. The petition for rehearing with suggestion for rehearing *en banc* was denied on December 5, 1996. Pet. App. 24a-25a. The petition for writ of certiorari was filed on March 4, 1996. Petitioner[1] seeks to invoke the jurisdiction of this Court under 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

1. 26 U.S.C. § 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or

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1. In order to avoid confusion between the petitioner in the United States Tax Court case below (the Estate of Mr. Hubert), and the petitioner for writ of certiorari in this Court (the Commissioner of Internal Revenue), the latter shall be referred to herein as "the Commissioner."

(3) in connection with the determination, collection or refund of any tax.

2. 26 U.S.C. § 641(b) provides:

COMPUTATION AND PAYMENT. — The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

3. 26 U.S.C. § 642(g) provides:

DISALLOWANCE OF DOUBLE DEDUCTIONS.— Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect of decedents).

4. 26 U.S.C. § 2053(a) provides:

GENERAL RULE. — For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts —

(1) for funeral expenses,

(2) for administration expenses,

(3) for claims against the estate, and

(4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,

as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

5. 26 U.S.C. § 2055 provides, in relevant part:

(a) IN GENERAL. — For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers —

* * *

(2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes. . . .

* * *

(d) LIMITATION ON DEDUCTION. — The amount of the deduction under this section for any transfer shall not exceed the value of the transferred property required to be included in the gross estate.

* * *

6. 26 U.S.C. § 2056 provides, in relevant part:

(a) ALLOWANCE OF MARITAL DEDUCTION. — For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

* * *

(b)(4) VALUATION OF INTEREST PASSING TO SURVIVING SPOUSE. — In determining for purposes of subsection (a) the value of any

interest in property passing to the surviving spouse for which a deduction is allowed by this section —

(A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and

(B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

7. 26 C.F.R. § 20.2056(b)-4(a) provides, in relevant part:

Marital deduction; valuation of interest passing to surviving spouse. —

(a) *In general.* The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to his surviving spouse is to be determined as of the date of the decedent's death. . . . The marital deduction may be taken only with respect to the net value of any deductible

> interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

8. 26 C.F.R. §§ 20.2056(b)-5(f)(1) and -5(f)(4) provide, in relevant part:

> **Marital deduction; life estate with power of appointment in surviving spouse.**
>
> * * *
>
> (f) *Right to Income.*
>
> (1) If an interest is transferred in trust, the surviving spouse is "entitled for life to all of the income from the entire interest or a specific portion of the entire interest," . . . if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life

> which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust.
>
> * * *
>
> (4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust [for want of entitlement to "all of the income"] unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. Such intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust [for want of entitlement to "all of the income"] are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus. . . .

STATEMENT OF THE CASE

This case concerns the federal estate tax liability of the Estate of Otis C. Hubert, formerly a resident of Georgia ("Mr. Hubert"). Mr. Hubert died in 1986, leaving an estate greater than

$30,000,000 which was divided between charity and his family. A Will contest ensued and was ultimately settled based upon an approximately equal division between the Hubert family and charity.

1. Upon the death of a decedent who had sufficient property value to invoke the estate tax, his "gross estate," less various deductions, is subject to tax. 26 U.S.C. § 2001. The amount of the gross estate is determined by the value of the decedent's property "at the time of his death." 26 U.S.C. § 2031. As well, 26 U.S.C. § 2056 provides for a deduction from the gross estate for certain property passing to the surviving spouse, known as the "marital deduction."[2] The measure of the marital deduction is again the value of the property passing to the surviving spouse "as of the date of the decedent's death." 26 C.F.R. § 20.2056(b)-4(a), *interpreting* 26 U.S.C. § 2056(a). The gross estate is also reduced by charitable contributions, with the measure of those contributions once again being "the value of property included in the decedent's gross estate," *i.e.*, the date-of-death value. 26 C.F.R. § 20.2055-1(a), *interpreting* 26 U.S.C § 2055. The object of these date-of-death valuations is to provide a uniform standard for measuring the property that comes into the estate and the property that leaves the estate, providing symmetry from an inclusion and deduction standpoint.

Neither the date-of-death value of the property going into an estate nor the date-of-death value of that same property going out of an estate is embellished by post-death income of the estate; such values would then no longer be "date-of-death." *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941). Consequently, post-death expenses properly paid out of that post-death income cannot and should not alter the date-of-death value of the

2. The property making up the marital deduction is included in the estate of the surviving spouse, if owned by her (or deemed to be owned by her) at the date of her death.

property going into the estate or the date-of-death value of that same property going out of the estate.

The administration of a decedent's estate is a process that occupies a span of time. As a consequence, many estates — especially complicated estates or those involved in litigation — will be subject to the income tax on estates provided by Subchapter J of the Internal Revenue Code during the period of administration. Such estates file a federal fiduciary income tax return (Form 1041), reporting their income and expenses and paying income tax on any net income.

In computing that income tax liability, 26 U.S.C. § 642(g) bestows upon every estate the flexibility of deducting estate administration expenses accrued post-death either on the estate tax return (Form 706) or the estate's income tax return (Form 1041). 26 U.S.C. §§ 2053, 642(g). An estate's choice of where to deduct post-death administration expenses is subject to certain restrictions. First, no "double deduction" may be claimed, and the estate must elect which return is to be used. Thus, administration expenses can be deducted either on the estate tax return or on the estate's income tax return.[3] Second, when estate corpus — *i.e.*, the value of the estate existing as of the date-of-death — is actually used to pay administration expenses or is required to be so used by state law or the testamentary documents, that corpus no longer exists and thus cannot be used to fund the marital, charitable or any other estate tax deduction. *Estate of Luehrmann v. Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961).

However, when neither state law nor the controlling

3. The "no double deduction" statute, 26 U.S.C. § 642(g), does not purport to speak to the computation of the marital or charitable estate tax deductions.

testamentary documents create any obligation to pay post-death administration expenses from estate corpus, no diminution of the marital, charitable or other estate tax deductions need occur if the expenses are paid from post-death income of the estate.[4] For this reason, the court of appeals in this case held that neither the date-of-death value of the property going into the estate nor the date-of-death value of the property going out of the estate is diminished by the authorized use of that post-death income to pay post-death expenses, provided that the payment is authorized by state law and the testamentary documents. *Estate of Hubert v. Commissioner*, 63 F.3d 1083 (11th Cir. 1995), *aff'g* 101 T.C. 314 (1993).

2. Mr. Hubert's Will, executed in January 1982, left the residue of his estate in trust, the income of which was to be paid to his wife, with the remainder to charity. One of three codicils removed a general power of appointment that had been granted to Mr. Hubert's wife in his Will.

After five years of litigation among Mr. Hubert's family, his

4. As the Tax Court established in its first footnote, 101 T.C. at 315 n.1 (Pet. App. at 26a), the single most important distinction in this case lies in not confusing, as the Commissioner has throughout this case, the concept of "marital/charitable share" or "marital/charitable portion" with the very different concept of "marital/charitable deduction." The former terms refer to total assets passing to the surviving spouse or charity under the settlement agreement (including both date-of-death value of estate *corpus* and the post-death net *income*), whereas the latter term refers only to the date-of-death value of the estate *corpus* passing to the spouse or charity. That same confusion tripped up both the Sixth Circuit in *Estate of Street v. Commissioner*, 974 F.2d 723, 727 (6th Cir. 1992), and the Federal Circuit in *Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied*, 114 S. Ct. 546 (1993). Both courts assumed that because income increased the marital portion, expenses paid with that income decreased the marital deduction. As shown above, that assumption does violence to the date-of-death concept built into the inclusion and deduction computations.

nephew (who drafted the Will and codicils) and the Cobb County district attorney and the Georgia Revenue Commissioner as representatives of the charitable beneficiaries, the Cobb County Probate Court entered an Order which disposed of the residuary estate and all codicil provisions related to the residuary in a manner different than the Will. In lieu of the Will, the Order divided the entire residuary estate (including corpus and income) between the marital and charitable shares ("Marital Share" and "Charitable Share"). The Marital and Charitable Shares included both estate corpus in existence as of the date-of-death and post-death income earned on that corpus. Just as post-death income had been allocated between the two Shares, so were post-death administration expenses allocated between the Marital and Charitable Shares.

Under Georgia probate law, an executor may charge payments of administration expenses either against the income of the estate or against corpus, if the Will so provides. GA. CODE ANN. § 53-15-3 (Michie 1982). In this case, Mr. Hubert's Will authorized the executors "to charge any expense against income or principal or apportion the same." Acting pursuant to this authority, the executors charged $506,989 of administration expenses against corpus, and as permitted by 26 U.S.C. § 2053(a)(2), those charges were deducted from the gross estate for purposes of the federal estate tax. All other administration expenses were charged by the executors against the post-death income earned by the estate and were deducted from that income during the period of administration for purposes of the federal income tax. 26 U.S.C. § 212.

In accordance with the dictates of 26 U.S.C. §§ 642(g) and 2053(a)(2), the executors of Mr. Hubert's estate reduced the amount of the marital and charitable deductions claimed on the estate tax return by the amount of administration expenses charged against corpus, since those expenses reduced corpus

existing as of the date-of-death. Because post-death administration expenses paid out of post-death income did not and could not reduce the date-of-death valuation of the corpus, the executors did not make such a reduction for the administration expenses charged against post-death income; the executors deducted those expenses on the estate's income tax return pursuant to 26 U.S.C. §§ 212 and 642(g).

3. An example based upon the values in this case best sets forth the issue. Assume that the stipulated value of the gross estate on the date-of-death was $30 of corpus, that $2 of that corpus was used to pay administration expenses, and that the remaining $28 was split evenly between the spouse and charity, with actual corpus distributions to each of $14. This accounts for the entire $30. Assume further that $6 of post-death income is earned by the estate and that unanticipated additional administration expenses of $4 are incurred. These additional expenses are paid out of the $6 of income, leaving a net income of $2, all of which is reported on the estate's fiduciary income tax return (Form 1041). What comes in, goes out: the estate balances.

If the estate were promptly closed and the assets distributed to a trust for the benefit of the spouse and charity, the trust would simply report its income and expense on the trust's fiduciary income tax return. The estate would have no estate tax due, providing symmetry by fully accounting for the date-of-death corpus in distributions which qualified for the marital and charitable estate tax deductions. In turn, the true net income of the estate — the post-death income and administration expenses paid therefrom — would be reported by the trust on the fiduciary income tax return. Again, what comes in, goes out.

However, when, as here, closing of the estate takes some time, the result of the Commissioner's position is as follows:

despite the fact that $14 of date-of-death corpus is actually distributed to the spouse and $14 of date-of-death corpus is actually distributed to charity, the federal estate tax will artificially assume that only $12 of corpus passes to each:

	$30	gross estate
-	2	administration expenses paid from corpus
-	4	administration expenses paid from income
	$24	estate remaining for distribution to beneficiaries
+	2	division of estate equally between spouse and charity
	$12	distribution to each of spouse and charity

This view leaves $4 of corpus missing from the gross estate, yet subject to estate tax. In other words, the $30 date-of-death corpus is distributed $2 for expenses paid from corpus, $12 to the spouse and $12 to charity, for a total of only $26. Thus, $4 of corpus disappears, but not before it is taxed. In order to avoid having this disappearing residuary taxed on the estate tax return, the executor is forced to deduct the $4 of administration expenses paid from post-death income on the estate tax return, rather than the estate's income tax return. The result, as to the estate's income tax return, is an illegal income tax on gross, not net, income. Thus, the Commissioner's approach — examined from either viewpoint — results in a distortion: what comes in does not go out for estate tax purposes (producing the disappearing residuary described above) or does not go out for income tax purposes (producing an illegal tax on gross income).

4. After issuing a notice of estate tax deficiency on other grounds, the Commissioner raised a new issue in the Tax Court.

She contended that the marital and charitable deductions had been overstated by the total administration expenses, without regard to the source of their payment, the effect of state law, or the effect of any elections made by the executors. Because this new issue was not set forth in the notice of estate tax deficiency, the Commissioner bore the burden of proof on all factual matters. TAX CT. R. PRAC. & PROC. 142(a).

5. In the Tax Court, the Commissioner conceded the grounds set forth in the notice of deficiency and went to trial on the new issue. As part of her trial preparation, the Commissioner stipulated that the marital deduction was $11,896,597 and that the charitable deduction was $11,840,385.[5] Stipulation ¶¶ 57-58, Resp. App. 2a-5a. In making that stipulation, the Commissioner reduced the marital and charitable deductions by interest she deemed had been implicitly earned on the assets of Mr. Hubert's estate — by $2,847,541 and $3,098,001, respectively. Finding no statutory support for such a reduction, the Tax Court refused to condone the Commissioner's concept of imputed interest earned on the assets of Mr. Hubert's estate; the Commissioner did not appeal this determination. When the Commissioner's stipulations are adjusted by the implicit interest issue which she lost in the Tax Court, the correct stipulation produces a marital deduction of $14,744,138 and a charitable deduction of $14,938,386. Stipulation ¶¶ 57-58, Resp. App. 2a-5a. On these

5. The Tax Court rules require that all parties "stipulate, to the fullest extent to which complete or qualified agreement can or fairly should be reached, all matters not privileged which are relevant to the pending case, regardless of whether such matters involve fact or opinion or the application of law to fact. . . ." TAX CT. R. PRAC. & PROC. 91(a)(1). "A stipulation shall be treated, to the extent of its terms, as a conclusive admission by the parties to the stipulation, unless otherwise permitted by the Court or agreed upon by those parties. The Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part. . . ." TAX CT. R. PRAC. & PROC. 91(e).

stipulations, the sum of the marital and charitable deductions exceeds the date-of-death residuary corpus. Hence, the Commissioner here seeks review of a position which will have no impact upon this case.

6. In a reviewed decision adopted verbatim by the majority of the court of appeals, the Tax Court held that the marital and charitable deductions were not reduced by post-death administration expenses properly allocated to post-death income pursuant to Georgia law and Mr. Hubert's Will. The Tax Court properly recognized that administration expenses "are incurred and accrued during administration and should not be confused with claims against the estate which existed and accrued at the date of death." 101 T.C. at 323. This conclusion does not lead to a double deduction forbidden by 26 U.S.C. § 642(g), which prohibits a deduction under 26 U.S.C. §§ 2053 or 2054 for an amount deducted on the estate's income tax return. Instead, the deductions in question are under 26 U.S.C. §§ 2055 and 2056, which the Tax Court pointed out are based on the date-of-death values of the property passing to the spouse and the charitable beneficiaries.

The Tax Court opined that the Commissioner's reliance on 26 C.F.R. § 20.2056(b)-4(a) was misplaced for the same reason that the Commissioner has failed throughout this litigation to mention the title of her own regulation, "Marital deduction; valuation of interest passing to surviving spouse." That regulation is precisely what its title states that it is — a valuation regulation for determining the value of the property passing to the spouse. Based on the facts of the case, the Tax Court found that the right to pay administration expenses out of post-death income was not a material limitation here on the right of the surviving spouse to receive that income. The Commissioner has never contested this fact-finding.

Further, the Tax Court pointed out that, pursuant to 26 U.S.C. § 2056(b)(4) and 26 C.F.R. § 20.2056(b)-4(a), the value of the interest passing to the spouse and the effect of any encumbrance is to be determined "as if the amount of a gift to the spouse were being determined." 101 T.C. at 325. The Tax Court held that, under the rules pertaining to gifts, the payment of administration expenses out of income is not a limitation on the spouse's right to income, a truth recognized by the Commissioner in her own instructions to auditors and taxpayers. 101 T.C. at 325, *citing* Rev. Rul. 69-56, 1969-1 C.B. 224.

The Tax Court rejected the Commissioner's contention that the legislative history of the marital deduction dealing with payment of claims out of an estate's post-death income requires a reduction of the marital deduction when administration expenses are paid out of that income. This legislative history nowhere refers to administration expenses. The Tax Court pointed out that claims against an estate are in existence at the date of death and thus burden the estate's corpus, but administration expenses arise after death and may relate to both corpus and post-death income. Logically, administration expenses may thus be charged to either post-death income or to corpus, while claims must be charged to corpus. 101 T.C. at 326.

The Tax Court disagreed with one prong of the two inconsistent conclusions reached by the Sixth Circuit in *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992), *aff'g in part & rev'g in part* 56 T.C.M. (CCH) 774 (1988), finding the Sixth Circuit's reliance on 26 C.F.R. § 20.2056(b)-4(a) and the legislative history to be misplaced. 101 T.C. at 328-329. The Tax Court disagreed with the Sixth Circuit's analysis that income earned by the estate increases the marital share and presumably the marital deduction, leading to a marital deduction greater than the amount actually distributable if expenses paid from income do not reduce the marital deduction. The Tax Court noted that

income earned on estate property is not included in the gross estate; and "as a result, under section 2056(a), such income does not lead to an increase in the amount of the marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate." 101 T.C. at 329.

Rejecting as artificial the Sixth Circuit's distinction in *Estate of Street* that the marital deduction need not be reduced for interest on estate and inheritance taxes paid out of the income of the estate but should be reduced for all other administration expenses, the Tax Court noted that the regulation relied upon by the Sixth Circuit is only an example of a situation in which the rule *may* be applied. That regulation does not purport to exclude interest on estate and inheritance taxes from the broader concept of administration expenses.

Instead, the Tax Court said that the controlling regulation was 26 C.F.R. § 20.2056(b)-5(f)(4). That regulation addresses the marital deduction when, as here, the spouse receives a life estate with a general power of appointment,[6] and it specifically addresses the "right to income" when the executor is given the discretion to pay expenses out of income. The regulation thus states that "the power to determine the allocation or apportionment of receipts and disbursements between income and corpus" is not a condition which will cause the spouse to have a right to less than "all of the income," as required by a general power of appointment trust, "if the local courts will impose reasonable limitations upon the exercise of powers." Coincidentally, these "reasonable limitations" had already been

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6. Under the settlement agreement, the Marital Share is divided between the general power of appointment trust and a qualified terminal interest trust. Principles identical to those contained in 26 C.F.R. § 20.2056(b)-5(f)(4) are applied to a qualified terminal interest trust by 26 C.F.R. § 20.2056(b)-7(d)(2).

litigated by the executor in this case. In the year before Mr. Hubert died, the Georgia Supreme Court held, in *Citizens & Southern National Bank v. Haskins*, 254 Ga. 131, 327 S.E.2d 192 (1985) (citations omitted):

> While there are rules for categorizing items as income or principal, the settlor may authorize the trustee to allocate interests to income which would otherwise be principal and vice versa. . . . When exercising this power the trustee must "act impartially as between income and principal beneficiaries. . . ."

Thus, the Commissioner's own regulation defers to state law in this area. As fortified by that state law, the regulation establishes that the discretion that Mr. Hubert bestowed upon his executors to pay expenses out of income is consistent with Mrs. Hubert's right to "all of the income" of the marital trusts for purposes of 26 U.S.C. § 2056 and does not alter the full marital deduction.

7. Commentators generally agree that the Tax Court's decision in this case is correct. *See* Schlenger, Madden & Hayes, *TC Reaffirms Its Position That Marital Deduction Is Not Reduced by Administration Expenses*, 21 ESTATE PLANNING 112 (1994); Pennell, 843 TAX MANAGEMENT ESTATES, GIFTS & TRUSTS PORTFOLIO (BNA) at A-29; Colburn, Englbrecht & Vollmers, *Administrative Expenses and the Marital Deduction*, 72 TAXES 412, 419 (1994).

REASONS FOR DENYING THE WRIT

The decision of the Eleventh Circuit Court of Appeals is correct. Further, review is not warranted because the stipulations and fact-findings of the Tax Court, unappealed by the Commissioner, prevent a reversal by this Court from having any numerical effect on the estate tax liability of Mr. Hubert's estate.

1. The Commissioner seeks certiorari on the basis of (a) a conflict within the circuit which decided this case and (b) a conflict among the courts of appeals.

a. The purported intra-circuit conflict — the same basis upon which the Commissioner sought *en banc* rehearing — was rejected out of hand by the court of appeals in this case in a per curiam opinion signed by Judge Dubina, who wrote the dissenting opinion in the Eleventh Circuit.[7] Although the Commissioner repeatedly asserts that the court of appeals' decision here is contrary to the binding precedent formed by *Alston v. United States*, 349 F.2d 87 (5th Cir. 1965); *Ballantine v. Tomlinson*, 293 F.2d 311 (5th Cir. 1961); and *Estate of Roney v. Commissioner*, 294 F.2d 774 (5th Cir. 1961), *aff'g per curiam* 33 T.C. 801 (1960), those assertions ignore the reasoning of those courts, which was to follow the controlling state probate law and testamentary provisions. Thus, when different state law property rights exist, different federal estate tax results necessarily follow.

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7. In order to file a petition for *en banc* review, the Commissioner certified to the court of appeals in this case that such an intra-circuit conflict existed. FED. R. APP. PROC. 35(a), *as interpreted by* 11TH CIR. R. 35-6(c) (certification required "that the panel decision is contrary to the following decision(s) of the Supreme Court of the United States or the precedents of this circuit and that consideration by the full court is necessary to secure and maintain uniformity of decisions in this court:"). Accordingly, the Eleventh Circuit faced this issue directly.

As the court of appeals noted here, in the words of the former Chief Judge of the Fifth Circuit[8] (63 F.3d at 1084 n. 1) (citations omitted):

> With due respect to the dissenting opinion, the two cases cited as binding authority are inapplicable in this case.
>
> In *Ballantine v. Tomlinson*, neither the will nor Florida law permitted the expenses there involved to be paid out of income. . . .
>
> Likewise in *Alston v. United States*, though Georgia law permitted it, there was no provision in the will for the payment of the administration expenses there involved from income. . . .
>
> There is nothing in either opinion that would indicate a result contrary to the one the tax court reached in this case.

All of these cases simply stand for the proposition that state law determines the property rights and probate interests of the parties, while federal law determines how those interests are taxed. *Morgan v. Commissioner*, 309 U.S. 78 (1940); *Blair v. Commissioner*, 300 U.S. 5 (1937). In each case, the applicable state law and the governing testamentary instruments called for expenses to be paid out of corpus. Indeed, the decisions of the

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8. Judge Roney, who wrote the majority opinion in the court of appeals in this case, was appointed to the bench in 1970 by President Nixon. As a consequence, he served on the Fifth Circuit for an 11-year period prior to the creation of the Eleventh Circuit, part of that time as Chief Judge. He thus was a member of the court which wrote the opinions in *Alston, Ballantine* and *Roney*.

Fifth Circuit in *Alston, Estate of Roney* and *Ballantine* each relied — at the urging of the Commissioner — upon applicable state law and the governing instruments calling for expenses to be paid out of corpus.

The Fifth Circuit continues to look to state law to determine the property interests of the parties. For example in *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993), the decedent's Will placed the bulk of her estate into two equal charitable lead residuary trusts. The charities received an annuity payment for 20 years at 8 ½% of the initial value of the trust assets. After 20 years, the trust assets were distributable to Mrs. Warren's children and grandchildren. The administrators of the estate asked the probate court for instructions regarding allocation of administration expenses because, under Texas law, expenses could be charged against either income or principal. The probate court ordered that expenses be charged 72.5% to income and 27.5% to corpus. Thus, the estate deducted 27.5% of the expenses on its estate tax return and the balance on its income tax returns (which is what happened in this case). The Fifth Circuit held that the probate court had applied state law properly in allocating the administration expenses between income and corpus and that, as a result, the administration expense charged to income and deducted on the estate's income tax returns did not reduce the charitable deduction. The *Estate of Warren* decision once again recognizes the controlling effect of state law on property rights.

The supposed intra-circuit conflict thus does not exist. The Fifth Circuit cases are all consistent with the court of appeals' decision in this case. The controlling state law and testamentary provisions in this case permitted the matching of post-death expenses and post-death income. No Fifth Circuit case holds to the contrary in the face of a state statute or Will which permits such a matching.

b. The conflict between this case and the Sixth Circuit opinion in *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992), *aff'g in part and reversing in part* 56 T.C.M. (CCH) 774 (1988), is one which was carefully considered by the Tax Court. Pursuant to the provisions of 26 U.S.C. § 7460(b), because of the Sixth Circuit's opinion, the Chief Judge of the Tax Court directed that the decision in this case be reviewed by the entire court.[9] In this case, 15 of 17 Tax Court judges ruled in favor of the matching principle followed by Mr. Hubert's estate.

The Tax Court's *en banc* decision pinpointed the conceptual misunderstanding of the Sixth Circuit, which is the same conceptual error the Commissioner urges upon this Court (101 T.C. at 329)(citations omitted):

> [W]e take issue with the Court of Appeals' analysis of the effect of income and expenses on the marital share. The court stated that income earned on estate property increases the marital share, and presumably the marital deduction, leading to a deduction greater than the amount distributed if payment of expenses from income does not reduce the marital deduction. However, income earned on estate property is not included in the gross estate. . . . As a result, under section 2056(a), such income does not lead to an increase in the amount of marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate.

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9. The United States Tax Court issued 611 opinions in 1993, the year in which it decided this case. Of those 611 opinions, only 11 — or 1.8% — were reviewed decisions.

Fisher v. United States, 28 Fed. Cl. 88 (1993), merely follows *Estate of Street*, adding nothing to the analysis.

Both the Commissioner here and the Sixth Circuit in *Estate of Street* fail to distinguish between the "marital share or marital portion" and the "marital deduction" (and their charitable counterparts). The "share/portion" term refers to the total assets passing to the surviving spouse or to charity under the settlement agreement, and includes both the date-of-death value of estate corpus and the post-death net income. The "deduction" term refers only to the date-of-death value of the estate corpus passing to the spouse and to charity. The Sixth Circuit's confusion of these two concepts led it astray in *Estate of Street*, because the Sixth Circuit assumed that, because income increased the marital share, expenses paid with that income decreased the marital deduction.

In *Burke v. United States*, the Federal Circuit conceded that state law governs the determination of property rights. Indeed, the controlling state law in *Burke* — like the controlling state law in *Alston, Ballantine* and *Roney* — required the payment of expenses out of corpus and thereby forced the same ultimate conclusion reached by the Federal Circuit in *Burke*. *Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied*, 114 S. Ct. 546 (1993). However, the *Burke* court framed the "pertinent question" as "whether payment of administration expenses must be accounted for in computing the value of a taxable estate under federal law for federal estate tax purposes regardless of the actual source of payment." 994 F.2d at 1580. This completely confuses the issue. Neither the marital share nor the charitable share are paid out of the "taxable estate." The relevant inquiry is not what is the taxable estate, but what is the residuary corpus payable to the marital share and the charitable share, which forms the marital and charitable deductions based on date-of-death values.

This misconception of the court in *Burke* leads to an asymmetrical result when expenses are properly charged to and paid from income and the executor elects to claim the administration expenses as an income tax deduction rather than as a deduction in reaching the taxable estate.[10] Because the Federal Circuit in *Burke*, like the Sixth Circuit in *Estate of Street*, was forced to judgment in these convoluted tax matters without the benefit of the Tax Court's exhaustive analysis in its reviewed decision in this case, errors occurred.[11] As one respected commentator has noted:

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10. *See* the example set forth at ¶ 3, pp. 12-13, *supra*.

11. No less an authority than Learned Hand once said:

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception — couched in abstract terms that offer no handle to seize hold of — leave in my mind only a confused sense of some vitally important but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plugging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have significance save that the words are strung together with syntactical correctness.

Hand, *Eulogy of Thomas Walter Swan*, 57 YALE L.J. 167, 169 (1947). Judge Hand thus points out the danger of judicial determinations made without an understanding of the tax system integrated as a whole, a problem to which the Sixth Circuit and Federal Circuit succumbed in *Estate of Street* and *Burke*.

> In confusing the amount actually passing to the charity and computation of the federal gross and then taxable estates, the court in *Burke* revealed that it had hardly a clue what was involved in the case. . . .

Pennell, 843 TAX MANAGEMENT ESTATES, GIFTS & TRUSTS PORTFOLIO: ESTATE TAX MARITAL DEDUCTION (BNA) at A-28. The court of appeals here was more astute.

In sum, the appellate decision in *Estate of Street* consists of two internally inconsistent conclusions, while the language relied upon by the Commissioner in *Burke* is *obiter dictum* since the same result is required by state law. The case *sub judice* is the only court of appeals' decision to consider the issue in light of the reviewed Tax Court decision issued subsequent to the conflicting conclusions drawn by the Sixth Circuit in *Estate of Street* and the *dictum* by the Federal Circuit in *Burke*. Hence, no clean conflict exists among the circuits. The issue should await review by this Court until and if a court of appeals chooses a different course after considering the exhaustive analysis of the *en banc* Tax Court.[12]

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12. The 15 Tax Court judges who ruled in favor of Mr. Hubert's Estate have, in the aggregate, 136 years of experience on the bench exclusively handling substantive federal tax disputes. Their appointments honor approximately 295 collective years of prior tax experience in government and in private practice at some of the most prestigious firms in the country. TAX CT. RPTR. (CCH) DOCKETS, PETITIONS, INDEX at 9215-9239.

This is thus an appropriate case to recall the words of Justice Jackson in *Arrowsmith v. Commissioner*, 344 U.S. 6, 12 (1952)(Jackson, J., dissenting):

> I think great deference is due the twice-expressed judgment of the Tax Court. . . . I still think the Tax

(Cont'd)

2. The Commissioner has not chosen the right case to review the issue appealed. As a matter of stipulated fact, no justiciable controversy exists in this case. Based upon the Commissioner's stipulations in the Tax Court, as corrected for the implicit interest discount unsuccessfully argued by the Commissioner and not appealed, the sum of the marital and charitable estate tax deductions in this case exceeds the date-of-death residuary corpus. *See* ¶ 3 at 12-13, *supra*; Stipulation ¶¶ 57-58, Resp. App. 2a-5a. As a consequence, no decision reached by this Court can have any impact on the estate tax due by Mr. Hubert's estate. The Commissioner's perception of an error of law is, at most, academic.

Thus, declining review in this case is consistent with the constitutional limitation on rendition of advisory opinions, U.S. CONST. Art. III, § 2, cl. 2, as well as the statutory preclusions of declaratory judgments in this type of tax case, 28 U.S.C. § 2201, and of appellate court reversals based on harmless error. 28 U.S.C. § 2111. Review in this Court should be granted only when this Court's judgment will have some material effect. *See St. Pierre v. United States*, 319 U.S. 41 (1943). On the basis of stipulated facts, the issue appealed by the Commissioner is a moot point. *Williams v. Zbaraz*, 448 U.S. 358, 367 (1980); *International Tel. & Tel. Corp. v. Alexander*, 396 F. Supp. 1150, 1160-1162 (D. Del. 1975).

3. The Commissioner's perceived question of law turns upon a question of fact that was resolved against the

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(Cont'd)

> Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs.

Accord, Inverworld, Ltd. v. Commissioner, 979 F.2d 868, 875 (D.C. Cir. 1992).

Commissioner in the Tax Court, was not appealed, and is unsuitable for this Court's review. The regulation upon which all of the Commissioner's arguments are bottomed is, as its caption states, a valuation regulation. 26 C.F.R. § 2056(b)-4(a), "Marital deduction; valuation of interest passing to surviving spouse." Valuation is a question of fact. The parties stipulated to the date-of-death value of Mr. Hubert's estate. Stipulation ¶ 50, Resp. App. 1a-2a. That stipulation was not conditioned upon the existence of any discount caused by the payment of estate administration expenses out of the income of the estate, nor did the Commissioner put on any evidence of such a discount, as was her duty based upon her failure to raise that issue in the statutory notice of deficiency.[13] Having reached that stipulation, the Tax Court held that "[o]n the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. . . ." 101 T.C. at 325. Because of this fact-finding, the Treasury Regulation on which the Commissioner relies, even if applicable, would produce the same result. The Commissioner could not, in light of her stipulation, appeal this fact-finding and did not do so. Thus, no factual predicate exists to merit the legal inquiry appealed.

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13. Based upon 26 C.F.R. §§ 2056(b)-5(f)(1) and -5(f)(4), as a matter of law, there could have been no valuation discount caused by the allocation of administration expenses. In all events, the Commissioner bears the burden of proof on these new issues, since they were not raised in the statutory notice of deficiency. TAX CT. R. PRAC. & PROC. 142(a).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX A — STIPULATION OF FACTS

UNITED STATES TAX COURT

DOCKET NO. 22333-90
JUDGE CLAPP

ESTATE OF OTIS C. HUBERT, DECEASED, CITIZENS & SOUTHERN TRUST COMPANY (GEORGIA) N.A., a national banking association, Temporary Administrator and Nominated Co-Executor,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

STIPULATION OF FACTS

IT IS HEREBY STIPULATED THAT, for purposes of this case, the following statements may be accepted as true, except as qualified herein, and all exhibits referred to herein and attached hereto, are incorporated in this stipulation and made a part hereof. Either party may introduce other and further evidence not inconsistent with the facts herein stipulated or the contents of the exhibits.

* * *

[Excerpts as follows:]

50. The gross estate and specific bequests based upon date of death values are as follows:

Appendix A

CALCULATION OF FORM 706 GROSS RESIDUE BASED ON DATE OF DEATH VALUES

GROSS ESTATE	$ 30,254,219
SPECIFIC BEQUESTS	
SPOUSE	$ (220,747)
CHURCHES	$ (400,000)
OTHERS	$ (30,000)

* * *

57. With respect to the Marital deduction attributable to the residuary estate, the position of the parties as to the amount of residuary corpus actually passing to Mrs. Hubert is as follows:

SECOND AND FINAL SETTLEMENT	**PETITIONER**	**RESPONDENT**
Para. 10 a.(1)	$ 14,390,000	$ 14,390,000
Para. 10 a.(1) and 17(a)		
$ 3,482,262		
($3,299,087)	$ 183,175	$ 183,175
Para. 10 a.(2)	$ 699,376	$ 699,376
Subtotal Marital	$ 15,272,551	$ 15,272,551
DIFFERENCES		
Para. 10 a.(1) (B) (Mar. Inc.)	($ 1,219,603)	
10 a.(2) (Mar. Inc.)	($ 699,376)	

Appendix A

Implicit Interest Income (7% from 6/2/87 to 10/10/90)		($ 2,847,541)
Para. 10 f.(3) Post-Agmt.		
Post Agmt. Inc. ($608,311 through 4/10/91)	No Effect on M.D.	-0-
Post Agmt. Exp. ($548,413 through 9/26/91; $398,269 through 4/10/91)	No Effect on M.D.	($ 548,413)
Allowable Resid. Mar. Ded.	$ 13,353,572	$ 11,896,597*

* **Respondent contends this amount is further reduced by 48 % of any estate taxes and interest due pursuant to Paragraph 10 c. and d. of the Second and Final Settlement Agreement and that the Estate's marital deduction is further limited to the actuarial value of the property passing to the spouse under decedent's will and codicils.**

58. With respect to the charitable deduction attributable to the residuary estate, Petitioner contends that, under Paragraph 10 e. of the Second and Final Settlement Agreement, the remainder of the residuary corpus and income is to be paid over to the charitable trust and that Petitioner is entitled to a charitable deduction of that remainder for Federal Estate tax purposes as follows (based on the assumption that the date of death residuary is $26,224,436 and the corpus allocated to the marital share is $13,353,572):

Date of Death Residuary - Corpus	$ 26,244,436
Allocated to Marital - Corpus	(13,353,572)
Balance to Charity - Corpus	$ 12,870,864

Appendix A

Respondent contends that, under Paragraph 10 of the Second and Final Settlement Agreement, the remainder of the residuary corpus and income is to be paid over to the charitable trust and that the amount of property actually passing to the charities from the residuary estate is as follows:

Adjusted Value as of 4/30/91 (ref. Stip. ¶ 46)	$ 29,176,334
Previously Distributed Inc.	$ 1,219,603
Marital Share before Implicit Int. Inc. and Post Agmt. Expenses	($ 15,272,551)
Share of Unpaid Post Agmt. Admin. Exp.	$ 185,000
Subtotal Charitable	$ 14,938,386
Less Implicit Int. Inc. (7% per annum) from 6/2/87 to 10/10/90	$ 3,098,001
Charitable Deduction Per Resp.	$ 11,840,385**

** **Respondent contends this amount is further reduced by 52 % of any estate tax and interest due pursuant to Paragraph 10 c. and d. of the Second and Final Settlement Agreement and that the Estate's charitable deduction is limited further to the actuarial value of the property passing to the charities under decedent's will and codicils.**

Petitioner maintains with respect to Respondent's calculation of the charitable deduction (a) that the proper starting number is the C&S value as of 4/30/91 of $32,095,354 rather than $29,176,334; (b) that the administrative expenses are payable out of income and do not reduce the residuary corpus

Appendix A

passing to the Charitable Trust; and (c) that the Estate has already dealt with the actual income passing to the Charitable Share as indicated on the Forms 1041.

* * *

(3)

Supreme Court, U.S.
FILED
APR 11 1996
CLERK

No. 95-1402

In the Supreme Court of the United States

OCTOBER TERM, 1995

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA), N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

DREW S. DAYS, III
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR PETITIONER

1. a. The court of apppeals expressly acknowledged that its holding in this case "brings us in conflict with the two other circuits which have decided the issue" (App., *infra*, 2a, citing *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993), and *Estate of Street* v. *Commissioner*, 974 F.2d 723 (6th Cir. 1992)). Respondents do not assert that the decision in this case is distinguishable from the conflicting decision of the Sixth Circuit in *Estate of Street*. Respondents claim, however, that the decision of the Federal Circuit in *Burke* v. *United States* is distinguishable from the present case on the theory that the decision in *Burke* was compelled by state law rather than by federal law (Br. in Opp. 23-24).

The court in *Burke*, however, expressly refused to base its decision on state law, correctly stating that the "pertinent question" is one of federal law. *Burke* v. *United States*, 994 F.2d at 1580.[1] The court explained (*ibid.*; footnote omitted):

> While we do not find error in the Court of Federal Claims' determination that under Florida law the will required administrative expenses to be paid out of the principal of the estate, we believe that the emphasis on the source of payment allowable under state law shifts the focus of the case from the pertinent question—whether payment of administrative expenses must be accounted for in computing the value of a taxable estate under federal law for federal estate tax purposes regardless of the actual source of payment.

The court in *Burke* then proceeded to "examine the federal estate tax statutes" to decide the "pertinent question" of federal law. *Ibid.* Relying solely on federal law, the Federal Circuit reached a conclusion in *Burke* that the Eleventh Circuit has acknowledged is "in direct conflict" with the decision in the present case (Pet. App. 2a).

The decision in this case also conflicts with the decisions of the Fifth Circuit in *Alston* v. *United States*, 349 F.2d 87 (1965), *Ballantine* v. *Tomlinson*, 293 F.2d 311 (1961), and *Estate of Roney* v. *Commissioner*, 294 F.2d 774 (1961), aff'g per curiam 33 T.C. 801 (1960). Respondents mischaracterize these cases as creating only a "purported intra-circuit conflict" (Br. in Opp. 19). These decisions are binding on both the Fifth Circuit and the Eleventh Circuit (Pet. App. 21a-22a (Dubina, J., dissenting)). See Pet. 16 n.4. The contrary decision of the Eleventh Circuit in this case thus creates both an inter-circuit and an intra-circuit conflict.[2]

[1] See also *Burke* v. *United States*, 994 F.2d at 1581:

> [T]he deduction of administrative expenses as provided for by federal law—as opposed to the actual payment of administrative expenses as allowed under state law—must come from, i.e., be accounted for within, the gross estate.

b. The decisions in *Burke*, *Estate of Street*, *Ballantine*, *Alston* and *Estate of Roney* properly reject the untenable contention accepted by the court of

[2] Respondents err in contending that *Alston* v. *United States* and *Ballantine* v. *Tomlinson* turn on state law rather than on federal law. In *Alston*, the Fifth Circuit relied on the federal statutory scheme in holding that the marital deduction must be reduced by the amount of administration expenses. The court stated (349 F.2d at 89):

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * *" as argued by the executors.

In *Ballantine*, as in the present case, state law and the decedent's will permitted expenses to be paid from either corpus or income, and the executors chose to pay them from income. The court relied on federal law in holding that administration expenses that burden the marital bequest reduce the value of that bequest and therefore reduce the marital deduction (293 F.2d at 312-313):

> At the decedent's death his estate had the obligation of paying estate taxes, debts, charges and expenses of administration. * * * It follows then that the legacy to the decedent's spouse * * * was charged, at his death, with a like part of the expenses of administration, even though the amount of such expenses might not then be ascertainable.

appeals in this case that an estate may alter the estate tax consequences of its payment of administration expenses simply by altering its method of accounting for such payments—charging the expenses against the interest of the spouse in the "income" rather than the "corpus" of the estate. Administration expenses are an encumbrance on the gross estate that exists at the date of death, even though the amount of these expenses is not then ascertainable. When that encumbrance falls upon the portion of the estate that comprises the marital or charitable bequest—whether paid from the "income" or the "corpus" of the estate attributable to those bequests—it reduces the value of that portion of the estate and therefore reduces the marital or charitable deduction under Sections 2055 and 2056. 26 U.S.C. 2055, 2056. See Pet. 11 n.2 & 18-22.

Prior to the decision of the Eleventh Circuit in this case, the courts of appeals had consistently concluded that, when a marital bequest is burdened by the obligation of paying administration expenses, such payments reduce the value of the bequest and therefore reduce the amount of the marital deduction. Those courts had thus consistently concluded that the Commissioner's interpretation of these statutory provisions is correct. As Judge Beghe noted in his dissent in the Tax Court (Pet. App. 77a), academic and professional opinion also supports the Commissioner's position on this issue. See, *e.g.*, Brogan and Painter, *Administration Expenses May Lower Other Deductions*, 21 Estate Planning 131, 136, 137 (May/June 1994) (describing *Estate of Hubert* as an "astounding decision" that "contravenes the reasoning and holdings of the circuit courts that have endured over the years"); Irwin, *Tax Law: Administrative Expenses and the Charitable and Marital Deductions—The Potentially Painful Surprise of a 642(g) Election*—Estate of Hubert *v.* Commissioner, 20 U. Dayton L. Rev. 501 (1994).

2. Respondents contend here, as they did in the court of appeals, that a justiciable controversy does not exist in this case because "no decision by this Court can have any impact on the estate tax due [from the] estate" (Br. in Opp. 26). That inherently factual contention is illogical and lacks support in the record of this case. The Eleventh Circuit properly declined to address it.

Respondents' contention is purportedly premised on calculations they have made concerning the effect on the estate tax liability of the Commissioner's loss of a different legal issue, involving imputed interest earned on assets of the estate (Br. in Opp. 26; see Pet. 12 n.3). What respondents have overlooked in making these new calculations, however, is that the Commissioner's loss on that different issue was taken into account in the computations (under Tax Court Rule 155) that formed the basis for the Tax Court's decision that the estate had overpaid its estate taxes by $344,428.

The Commissioner has performed a tentative recalculation of the estate tax liability in this case based on the assumption that the marital and charitable deductions are to be reduced by the administration expenses that had been deducted on the estate's income tax returns for the period prior to September 26, 1991 ($1,656,859). That recalculation was submitted to the court of appeals and is attached as an appendix to this brief (App., *infra*, 1a-3a). This recalculation reveals that, if the Commissioner's position in this case were sustained, (i) the overpay-

ment of $344,428 determined by the Tax Court would be eliminated and (ii) the estate would be liable for an estate tax deficiency of $154,535.06. See App., *infra*, 1a-3a.

The Commissioner's tentative recalculation of the taxes owed by the estate is understated, for it takes into account only those administration expenses that had been incurred by September 1991. Five additional years have now elapsed, and the estate has incurred additional administration expenses that would further reduce the marital and charitable deductions and correspondingly increase the estate tax deficiency. There is thus a live and growing controversy in this case.[3]

---

[3] Respondents' view that there is no justiciable controversy is premised, in part, on a comparison of the date-of-death residuary corpus ($26,224,436) with the sum of the marital deduction ($14,744,138) and the charitable deduction ($14,938,386) as adjusted by respondents' calculations of the effect of the implicit interest discount (Br. in Opp. 14, 26). Since the sum of the deductions (as calculated by respondents) exceeds the date-of-death residuary corpus, respondents contend that no taxes would be owed. But the estate tax is imposed on the *gross estate* less authorized deductions; the residuary value of the estate is not relevant in making that calculation. When the marital and charitable deductions are reduced by the the administration expenses incurred by the estate and paid from those interests (through September 1991), the estate has a net taxable value and an estate tax deficiency in excess of $150,000 (App., *infra*, 1a). The taxes owed would be even greater if additional administration expenses have been incurred and charged against the marital and charitable bequests since 1991. Under the decision of the court of appeals, however, a refund of more than $300,000 in taxes is required. Because the correct disposition of the question presented in this case will affect the estate's tax liability, the controversy is justiciable, not hypothetical or moot.

3. Respondents suggest that, by stipulating to the date of death value of Mr. Hubert's estate, the Commissioner has implicitly stipulated to the legal conclusion that administration expenses that are burdens on the marital interest in the estate do not reduce the marital deduction (Br. in Opp. 26-27). That contention is frivolous.

Neither the courts below, nor the parties, have had any doubt that the question presented in this case is a dispute about an issue of law—whether the marital and charitable deductions allowed by Sections 2055 and 2056 of the Internal Revenue Code are to be reduced by the expenses of administration of the estate that burdens those interests. It is that question of law that the court of appeals resolved adversely to the government and, in doing so, created a conflict among the circuits that warrants resolution by this Court.

As we have noted (Pet. 22-23), the question presented in this case commonly arises and is frequently litigated. Because the proper application of these estate tax provisions is an issue that must be confronted by any estate that contains a bequest to a spouse which—as is ordinarily the case—is burdened by the obligation to pay administration expenses, the question presented in this case arises for countless taxpayers. Resolution of this recurring question by this Court is needed to avoid continuing uncertainty and to assure even-handed application of the revenue laws.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

DREW S. DAYS, III
Solicitor General

APRIL 1996

Dept of the Treasury - Internal Revenue Service — ADDENDUM

NAME: Estate of Otis C. Hubert
SSN: 252-05-1011
DATE OF DEATH: 02-Jun-86

GROSS ESTATE-PER RETURN	30,263,421.00	
ADJUSTMENTS-PER ATTACHMENT #1	0.00	
GROSS ESTATE-AS CORRECTED		30,263,421.00
FIXED DEDUCTIONS-PER RETURN	2,773,203.00	
ADJUSTMENTS-PER ATTACHMENT #1	25,139,410.00	
FIXED DEDUCTIONS-AS CORRECTED		27,912,613.00
INTEREST DED - PER ATTACHMENT #1		0.00
MARITAL DED - PER ATTACHMENT #2		220,747.00
CHARITABLE DED - PER ATTACHMENT #2		200,000.00
TAXABLE ESTATE-AS CORRECTED		1,930,061.00
ADJUSTED TAXABLE GIFTS		0.00
TAXABLE ESTATE PLUS ADJUSTED TAXABLE GIFTS		1,930,061.00
GROSS ESTATE TAX		749,327.45
LESS: AGGREGATE GIFT TAX		0.00
UNIFIED CREDIT		155,800.00
NET		593,527.45
LESS: ST DEATH TAX CR		2,957.00
GIFT TAX CR		0.00
FOREIGN TAX CR		0.00
CR FOR TAX ON PRIOR TRANS		0.00
TOTAL TAX LIABILITY		590,570.45
TAX-PER RETURN OR AS PREVIOUSLY ADJUSTED		344,428.00
GROSS DEFICIENCY (OVERASSESSMENT)		246,142.45
LESS: ADD'L ST DEATH TAX CR - IF SUBSTANTIATED		91,607.39
NET DEFICIENCY (OVERASSESSMENT)		154,535.06

Dept of the Treasury - Internal Revenue Service

Estate of Otis C. Hubert — ATTACHMENT #1

ADJUSTMENTS TO GROSS ESTATE

# 1	_____	0.00
# 2	_____	0.00
# 3	_____	0.00
# 4	_____	0.00
# 5	_____	0.00
# 6	_____	0.00
# 7	_____	0.00
# 8	_____	0.00
# 9	_____	0.00
# 10	_____	0.00
# 11	_____	0.00
# 12	_____	0.00
TOTAL ADJUSTMENTS		0.00

ADJUSTMENTS TO FIXED DEDUCTIONS

# 1	_____	12,525,143.00
# 2	_____	12,042,434.00
# 3	_____	200,000.00
# 4	_____	371,833.00
# 5	_____	0.00
# 6	_____	0.00
# 7	_____	0.00
# 8	_____	0.00
# 9	_____	0.00
# 10	_____	0.00
# 11	_____	0.00
# 12	_____	0.00
TOTAL ADJUSTMENTS		25,139,410.00

Dept of the Treasury - Internal Revenue Service

Estate of Otis C. Hubert — ATTACHMENT #2

COMPUTATION OF RESIDUE

CORRECTED GROSS ESTATE		30,263,421.00
LESS: CORRECTED FIXED DEDUCTIONS		27,912,613.00
INTEREST DEDUCTION		0.00
FIXED MARITAL DEDUCTION		220,747.00
FIXED CHARITABLE DEDUCTION		200,000.00
FEDERAL ESTATE TAX TIMES	0.00000000%	0.00
STATE DEATH TAX PD TIMES	0.00000000%	0.00
OTHER RESIDUE REDUCTIONS		4,808,000.00
CORRECTED RESIDUE AMOUNT		0.00

(4)

No. 95-1402

Supreme Court, U. S.
FILED
JUN 13 1996
CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1995

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED,
C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

**On Writ of Certiorari to the
United States Court of Appeals
for the Eighth Circuit**

JOINT APPENDIX

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Counsel of Record
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Solicitor General
Department of Justice
Washington, D.C. 20530
(202)514-2217

PETITION FOR CERTIORARI FILED MARCH 1, 1996
CERTIORARI GRANTED APRIL 29, 1996

79pp

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UNITED STATES TAX COURT

Docket No. 22333-90

ESTATE OF OTIS C. HUBERT, DECEASED,
C&S/SOVERAN TRUST COMPANY (GEORGIA), N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

v.

COMMISSIONER OF INTERNAL REVENUE

DOCKET ENTRIES

DATE	FILINGS AND PROCEEDINGS
10/05/90	PETITION Filed: Fee Paid
10/05/90	DESIGNATION of Trial at Atlanta, GA
11/20/91	ANSWER (C/S 11/15/90).
05/24/91	NOTICE of Trial on 1028/91 at Atlanta, GA.
05/24/91	STANDING PRE-TRIAL ORDER attached to Notice of Tiral
08/16/91	REQUEST FOR ADMISSIONS by Petr. (C/S 08/14/91)
09/09/91	MOTION by resp. for protective order. C/S
09/09/91	MOTION by resp. to continue trial generally. C/S
09/11/91	ORDER Resp. mot. for protective order is Gr.
09/11/91	ORDER Petr. by 10-4-91 file response to mot. to continue.

DATE	FILINGS AND PROCEEDINGS
09/19/91	MOTION by petr. to reconsider Order dtd. 9/11/91 C/S w/Exh.
09/27/91	ORDER parties file joint status report by 10-11-91. Mot for recons. is gr. Order dtd. 9-11-91 granting mot for protective order is vacated. Motion for protective order is taken under advisement.
10/04/91	OBJECTION by Petr. to Mot. to Continue. C/S
10/11/91	REPORT (JOINT) filed.
10/23/91	MOTION by petr. to substitute fiduciaries & change caption. (N. Obj.) C/S
10/23/91	MOTION by petr. to Amend Petition. (Am. to Pet. Ld) C/S
10/24/91	MOTION by petr. for partial summary judgement. w/Ex., Affidavits & Memo. C/S
10/25/91	ORDER mot. to substitute Gr.; caption amended.
10/25/91	ORDER mot. to amend pet. Gr.
10/25/91	AMENDMENT TO PETITION
10/25/91	ORDER set 10/28/91 Atlanta, GA on mot. for partial summ. judg.
10/28/91	HEARING before Judge Clapp at Atlanta, GA Also called 11-4. Mot. filed 9/9—See Order Mot. filed 10/24—Dn. JURISDICTION RETAINED, JUDGE CLAPP
11/04/91	ORDER mot. to cont. Gr. in that Parties by 12-4-91 submit dec. docu., submit case fully stipulated or file a stip. of settled issues.
11/07/91	ANSWER TO AMENDMENT TO PETITION. (Served Per Judge)
11/29/91	TRANSCRIPT of 10-28-91 rec'd.
11/29/91	TRANSCRIPT of 11-4-91 rec'd.

DATE	FILINGS AND PROCEEDINGS
12/19/91	STIPULATION of Agreed Issues.
12/19/91	STIPULATION of Facts w/Exs.
12/19/91	JT. MOTION to submit case under Rule 122.
12/19/91	JT. MOTION to sever issue from Rule 122 proceeding. (Per Judge)
02/26/92	ORDER that case is submitted to Judge Clapp. Jt. mot to submit case Gr. Orig. Brfs. due 3/3/92. R. Brfs. due 4/22/92. Action on Jt. mot. to sever issue is deferred.
03/02/92	BRIEF for resp.
03/04/92	BRIEF for petr. C/S (Leave Gr)
04/22/92	REPLY BRIEF for resp.
04/23/92	MOTION by petr. to file Brief. (Brief Ld)
04/28/92	BRIEF for petr.
10/19/93	ORDER Resp. mot. for protective order & the joint mot. to sever issue are deemed moot.
10/19/93	MEMORANDUM OPINION, Judge Clapp T.C. Memo. 1993-482 (Opinion rendered on charitable deduction issue.)
10/19/93	T.C. OPINION, Judge Clapp 101 T.C. No. 22 (Decision will be entered under Rule 155)
10/27/93	ENTRY OF APPEARANCE by David W. Seigel.
12/10/93	AGREED COMPUTATION
12/10/93	SETTLEMENT STIPULATION
12/14/93	DECISION ENTERED, Judge Clapp

DATE	FILINGS AND PROCEEDINGS
	APPELLATE PROCEEDINGS
03/09/94	NOTICE OF APPEAL by resp. to U.S.C.A., 11th Cir.
03/10/94	NOTICE of Filing with copy of notice of appeal mailed to counsel of record for petrs.
03/10/94	NOTICE of assembling & date for transmission of record.

UNITED STATES COURT OF APPEALS
FOR THE EIGHTH CIRCUIT

No. 94-8287

ESTATE OF OTIS C. HUBERT, DECEASED,
C&S SOVERAN TRUST COMPANY (GEORGIA), N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,
PETITIONER-APPELLEE

versus

COMMISSIONER OF INTERNAL REVEUNE,
RESPONDENT-APPELLANT

DOCKET ENTRIES

DATE	PROCEEDINGS
5/11/94	Appellate Docketing Statement
3/18/94	Staff Atty Jurisdiction IRS
3/24/94	Probable Jurisdiction Noted
4/14/94	Certified List
4/14/94	ROA (# Vols. 3)
4/20/94	Briefing Notice Issued
7/5/94	Brief for Appellant
7/5/94	Record Excerpts
8/9/94	Brief for Appellee
9/26/94	Reply Brief for Appellant
2/28/95	Supp. Authority-Apt

DATE	PROCEEDINGS
5/27/94	Apt Brief
8/19/94	Reply Brief
11/07/95	Flg. Appellee's motion for permission to file response to appellant's petition for rehearing with suggestion for rehearing en banc and Appellee's response to appellant's petition for rehearing with suggestion for rehearing en banc. lot COURT—11-08-95.lot
11/14/95	Flg. ORDER: The appellee's motion for permission to file response to appellant's petition for rehearing is GRANTED. JFD. lot
1/5/95	Argument Scheduled for 2/28/95 in ATLANTA #339
2/28/95	Case Argued—By Apt X By Ape X
9/12/95	Opinion Issued
9/12/95	Judgment Entered
12/19/95	Judgment & Opinion Issued to Clerk as Mandate
12/19/95	Record on Appeal Returned to Clerk (3 Vols.)
10/27/95	Petition for Rehearing to court 10-30-95
12/5/95	Order Denying Rehearing
3/07/96	Notice of Flg. Cert. on 3-1-96
11/08/95	Jonathan Cohen, DOJ, does not oppose motion to respond to PFR en banc. lot
11/14/95	Mot-2 for order on allowing response to Petition for Rehearing. lot
12/5/95	REHG-1 for order denying PFR. lot

[Filed Oct. 5, 1990]

UNITED STATES TAX COURT

Docket No. 22333-90

ESTATE OF OTIS C. HUBERT DECEASED; CITIZENS & SOUTHERN TRUST COMPANY (GEORGIA) N.A., a national banking association, Temporary Administrator and Nominated Co-Executor, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

PETITION

PETITIONER HEREBY PETITIONS this Court for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in his Notice of Deficiency dated August 31, 1990, and, as the basis for its case, alleges as follows:

1. Petitioner, a national banking association with its principal places of business and principal office located in Fulton County, City of Atlanta, Georgia whose mailing address is P.O. Box 12448, Atlanta, Georgia 30355, is the Temporary Administrator of the Estate of Otis C. Hubert, Deceased, having received Temporary Letters of Administration on August 15, 1986, by the Judge of the Cobb County, Georgia Probate Court. Otis C. Hubert (the "Deceased") died on June 2, 1986, being a legal resident on that date of the City of Marietta, Cobb County, Georgia. Decedent's Social Security Number was 252-05-1011. Form 706, the United States Estate Tax

Return (the "Estate Tax Return") was filed by Petitioner on or about September 2, 1987 with the Internal Revenue Service Center in Chamblee, Georgia.

2. The Notice of Deficiency, a copy of which is attached hereto and marked "Exhibit A", was mailed to Petitioner on or about August 31, 1990, and was issued by the office of the Internal Revenue Service in Atlanta, Georgia.

3. The deficiency determined by the Commissioner is in estate tax in a total amount of $14,052,146.00, all of which is in dispute.

4. The determination of tax set forth in Respondent's statutory notice is based upon the following errors:

A. In determining that a deficiency in estate taxes is due and owing in any amount.

B. In determining that the Estate is not entitled to the deductions in the amount of $12,650,592.00 claimed on Schedule M.

C. In determining that the Estate is not entitled to the charitable deductions claimed with regard to the bequests to the Redfort C. Trammell Subtrust and Rolland Cornelius, Jr. Subtrusts, which were reported on Schedule O of the Estate Tax Return as charitable bequests in the amount of $100,000.00, each.

D. In determining that the gross estate should not be reduced by the $12,502,655.00 reported for the bequest to the O. H. Hubert Charitable Trust, identified on line 6 of Schedule O of the Estate Tax Return and for which the estate claimed a charitable deduction.

E. In failing to recognize added costs of administration and other deductible expenses.

5. The facts supporting Petitioner's case are, among others, as follows:

A. Petitioner owes no deficiencies in estate tax.

B. Otis C. Hubert ("Mr. Hubert"), a resident of the city of Marietta, Cobb County, Georgia, died on June 2, 1986 leaving a substantial estate.

C. At the time of Mr. Hubert's death, the most recent wills and codicils purportedly executed by Mr. Hubert were as follows:

DATE OF EXECUTION	DOCUMENT
December 2, 1975	1975 Last Will and Testament ("1975 Will")
August 5, 1977	First 1977 Last Will and Testament ("First 1977 Will")
November 7, 1977	Second 1977 Last Will and Testament ("Second 1977 Will")
December 29, 1977	First Codicil to Second 1977 Will
October 27, 1978	Second Codicil to Second 1977 Will
September 18, 1977	Third Codicil to Second 1977 Will
May 15, 1981	Fourth Codicil to Second 1977 Will
January 7, 1982	Last Will and Testament ("1982 Will")
February 4, 1982	First Codicil to 1982 Will
February 19, 1982	Second Codicil to 1982 Will
June 8, 1983	Third Codicil to 1982 Will

D. A dispute arose before Mr. Hubert's death between Mr. Hubert and his nephew, Mr. Robert H. Owen ("Mr. Owen");

E. Mr. Owen is the author of certain of the Codicils to the 1977 Will pertaining to religious beneficiaries, the 1982 Will, and the three Codicils to the 1982 Will [(including the Second Codicil which struck the general power of appointment previously granted decedent's spouse Ruth S. Hubert

("Mrs. Hubert")], granted in every prior Will and Codicil executed by Mr. Hubert);

F. On July 3, 1986, Citizens and Southern Trust Company (Georgia), N.A. ("C&S"), as successor by affiliate transfer to the Citizens and Southern National Bank, filed a petition with the Probate Court of Cobb County, Georgia to probate the 1982 Will and its three Codicils in common form, there being no similar application by the other named Co-Executor, Mrs. Hubert;

G. A dispute arose shortly after Mr. Hubert's death between various members of Mr. Hubert's immediate family; namely, Mrs. Hubert, Richard N. Hubert ("Richard": (Decedent's son), Marilyn Hubert Kemper ("Marilyn" :a daughter of the Decedent), Judith Hubert Manning ("Judith": (second daughter), and Deborah Hubert Jones ("Deborah": (another daughter) (collectively the "Hubert Family"), and Mr. Hubert's nephew, Mr. Owen, with respect to the contentions on the part of the Hubert Family that Mr. Owen had unduly influenced Mr. Hubert to the benefit of himself and religious charities Mr. Owen favored to the detriment of Mrs. Hubert, and the contentions of Mr. Owen that the 1982 Will and its three Codicils represented Mr. Hubert's true intentions with respect to the charities, Mrs. Hubert and Mr. Owen despite the alleged attempts by the Hubert Family to prejudice Mr. Owen and the charities;

H. On July 18, 1986, as a result of this dispute, Mr. Owen filed, in his role as successor Co-Executor and as a creditor of the Estate, a petition with the Cobb County Probate Court to probate in common form the 1982 Will and its three Codicils he had drawn;

I. An argument rose later that same day between Mr. Hubert's son, Richard, and Mr. Owen regarding

Mr. Owen's activities with respect to the Will and Mrs. Owen's employment;

J. On August 5, 1986, Mr. Owen, in his role as successor Co-Executor and as a creditor, filed in the Probate Court of Cobb County, a petition to probate in solemn form, the 1982 Will and the three Codicils he had drawn;

K. On August 14, 1986, Mrs. Hubert filed a Caveat with the Cobb County Probate Court challenging Mr. Owen's fitness to serve as a Co-Executor or Trustee;

L. On August 14, 1986, C&S was appointed by the Cobb County Probate Court as temporary administrator of the Estate and, therefore, sought the approval of the Cobb County Probate Court with respect to distributions, real estate transactions, and other significant matters;

M. On August 17, 1986, Mr. Owen moved to voluntarily dismiss both his solemn and common form petitions;

N. On August 22, 1986, Deborah filed a Caveat with the Probate Court of Cobb County alleging first, that the Codicils to the 1982 Will (including the Second Codicil revoking the general power of appointment bestowed upon her mother and legal benefactor) were not properly attested under Georgia Code 53-2-40 and other provisions of Georgia law; secondly, that the 1982 Will was ineffective in that Mr. Owen and his wife were not competent to serve as witnesses to the Will within the standards required by Georgia law; thirdly, that the 1982 Will and its three Codicils were the product of undue influence in contravention of Georgia Code § 53-2-6 and other provisions of Georgia law; fourthly, that the 1982 Will and Codicils were the product of fraud and hence, ineffective under Georgia Code § 53-2-7 and other provisions of Georgia law; fifthly, that the 1982

Will and and its three Codicils were the products of mistake and are, therefore, unenforceable; and, finally, that at the time of executing the 1982 Will and Codicils, Mr. Hubert lacked the testamentary capacity required by Georgia Code § 53-2-6 and other provisions of Georgia law;

O. On August 22, 1986, Mrs. Hubert objected to the dismissal sought by Mr. Owen on the grounds that her earlier action constituted a claim for affirmative relief and was therefore a bar to Mr. Owen's dismissal;

P. On August 22, 1986, Mrs. Hubert also sought sanctions for Mr. Owen's failure to appear for a deposition;

Q. On August 29, 1986, Mr. Hubert's other daughters, Judith and Marilyn, also filed a Caveat attacking the 1982 Will and Codicils alleging that Mr. Hubert was not of sound and disposing mind and memory at the time he executed these documents, that he suffered from monomania, that the 1982 Will was obtained by false representations, and that Mr. Hubert was the object of undue influence and therefore, did not freely and voluntarily execute the Will;

R. On September 5, 1986, Mr. Owen filed a complaint with the U.S. Department of Labor under the Wage and Hour law (29 U.S.C. Section 201, *et seq.*) against the Estate, its heirs at law, and counsel;

S. On October 3, 1986, the Probate Court of Cobb County entered an order allowing Mr. Owen to voluntarily dismiss his petitions to file the 1982 Will and Codicils in common and solemn form;

T. On November 6, 1986, Mrs. Hubert, as widow, heir, and Co-Executrix and Trustee of the Hubert Estate, filed an action against Mr. Owen in Cobb County Superior Court seeking a declaratory judgment and equitable direction (captioned *Ruth S. Hubert v. Robert H. Owen,* Cobb County Superior Court Civil Action No. 86-1647399), and alleging that Mr. Owen was unqualified to serve as either Co-Executor or Trustee and that he had abused the trust and confidence that Mr. Hubert has bestowed upon him;

U. On December 8, 1986, Mr. Owen filed an Answer and Counterclaim in *Ruth S. Hubert v. Robert H. Owen,* Cobb County Superior Court, Civil Action No. 86-1647399, seeking actual damages for compensation in the amount of $279,000 under Count I, actual damages to his reputation in the amount of $2,000,000 under Count II, actual damages for slander in the amount of $2,000,000 under Count III, and actual damages for abuse of process in the amount of $2,000,000 and exemplary damages in the amount of $50,000,000 under Count IV;

V. On June 24, 1987, a settlement agreement entitled "Agreement of Interested Parties," (a true and correct copy of which was provided to Respondent's Estate and Gift Tax Attorney) was entered into by and among Mrs. Hubert, Richard, Marilyn, Judith, Deborah, the foregoing collectively referred to as the "Hubert Family," Mr. Owen, and Thomas Charron, as District Attorney for Cobb County, Georgia;

W. The Agreement of Interested Parties purported to resolve all differences between the various beneficiaries, executors, and Trustees;

X. On July 22, 1987, C&S filed a Petition for Declaratory Judgment and Equitable Direction in the Superior Court of Cobb County under the caption *Citizens and Southern Trust Company (Georgia), N.A., as Temporary Administrator of the Estate of Otis C. Hubert and nominated Co-Executor and Co-Trustee under the Last Will and Testament of Otis C. Hubert, deceased v. Ruth S. Hubert, Richard N. Hubert, Marilyn H. Kemper, Judith H. Manning,*

Deborah H. Jones, Robert H. Owen, Thomas Charron, as District Attorney for the Cobb Circuit, and Marcus E. Collins, Sr., as State Revenue Commissioner, Civil Action File No. 87-14337622 and addressing the import of the Agreement of Interested Parties;

Y. On August 4, 1987, Mrs. Hubert voluntarily dismissed, without prejudice, her action against Mr. Owen in *Ruth S. Hubert v. Robert H. Owen,* Cobb County Superior Court, Civil Action No. 86-1647399;

Z. On September 5, 1987, the State Revenue Commissioner filed his Answer to the C&S Petition for Declaratory Judgment alleging the following defenses: that the Agreement of Interested parties terminated and defeated the purpose of the Charitable Trust; that it violated the spendthrift clause of the Will; that it deprived the Testator of his right to dispose of his property by Will; that it unlawfully placed the Trustees of the Charitable Trust in a position of conflict; that it was unenforceable due to a failure of consideration; that it was contrary to public policy; that it modified the terms of the Charitable Trust; that it did not represent a consent by all Interested Parties, specifically the charitable beneficiaries; that the State Revenue Commissioner was a necessary party to the agreement; that it was not fair and reasonable as to all parties; and that it suffered from other defects.

AA. On October 15, 1987 and following, the State Revenue Commissioner served requests for production of documents, interrogatories, and notices of deposition upon the parties to the Agreement of Interested Parties;

BB. On October 15, 1987, the State Revenue Commission also moved for a continuance of the hearing then set for October 28, 1987, stating as

his reason a need and a right to pursue discovery;

CC. On October 26 and 28, 1987, hearings were held on the Motion for Continuance filed by the State Revenue Commissioner and on the Petition for Declaratory Judgment and Equitable Direction filed by Citizens and Southern Trust Company;

DD. Following the presentation of evidence, arguments, and briefs, the Superior Court denied the Motion for Continuance filed by the State Revenue Commissioner, restricted the scope of the issues before it, and approved the Agreement of Interested Parties in response to the Petition for Declaratory Judgment and Equitable Direction;

EE. On December 7, 1987, the State Revenue Commission filed a Notice of Appeal with the Supreme Court for the State of Georgia;

FF. On September 7, 1988, the Supreme Court issued is published opinion in *Collins v. Citizens and Southern Trust Company, et al.,* Supreme Court Case No. 45575;

GG. On September 20, 1988, C&S filed a Motion for Reconsideration with the Supreme Court;

HH. On November 10, 1988, the Supreme Court issued a revised opinion confirming the right of the State Revenue Commissioner, Marcus E. Collins, Sr., to inquire into and contest the first settlement agreement;

II. Discovery was then taken of the parties to the first settlement agreement and of the State Revenue Commissioner;

JJ. Mrs. Hubert filed a Caveat in support of and in conjunction with the Caveats filed by her daughters, in the event that the first settlement agreement should be set aside by the upcoming trial and its appeals;

KK. That Caveat offered by Mrs. Hubert seeks first to restore her general power of appointment

over the entire Estate by striking the Second Codicil to the 1982 Will and alternatively, seeks to strike both the 1982 Will and its three Codicils in favor of the 1977 Will under which she would be entitled to a greater share than she was entitled to under the first settlement agreement;

LL. The discovery, along with the proposed Caveat by Mrs. Hubert, has brought to light information previously undisclosed to the State Revenue Commissioner, on the condition of and incidents relating to Mr. Hubert in his advances years;

MM. If the Revenue Commissioner is successful, the charities would obtain a greater amount than that provided in the first settlement agreement on Mrs. Hubert's Will and Codicils.

NN. If successful, Mr. Owen would obtain a recovery greater than that provided in the first settlement agreement;

OO. All parties to the Will contest and settlement agreement dispute have recognized that, in light of the ruling by the Supreme Court in this case, all parties have the legal right and standing to assert their respective claims and that there are genuine disputes as to material facts;

PP. All parties to the dispute recognized that the first Agreement of Interested Persons, if successful, represented a negotiated settlement of the will contest and of the testimentary dispute between the Hubert Family and Mr. Owen.

QQ. Petitioner made QTIP elections with regard to four specific pieces of property to be distributed into separate and identifiable trusts with income for life to the surviving spouse, the remainder interest to one of Decedent's four children and that the necessary QTIP elections were made on the Estate Tax Return with regard to each of the four Ruth S. Hubert Trusts created to hold those four specifically designated pieces of property.

RR. Respondent has properly admitted (in the report prepared by its duly authorized representative which report served as the basis for the Notice) the facts set forth in the prior subparagraph.

SS. As Respondent's Estate and Gift Tax Examiner also properly recognized, where the parties to a bona fide Will contest which presents legitimate challenge to a charitable interest, involving a charitable remainder trust that does not qualify for the marital deduction and where the information provisions of Section 2056(c)(3) were not complied with, reach a bona fide good faith settlement of the Will contest resulting in an immediate payment or distribution to the charity in a new form, just as the first settlement agreement would have done and the parties fully expect will eventually be entered into, the Estate would be entitled to a charitable deduction for the value of the property distributed outright to the charitable trust![1]

TT. Respondent's duly authorized representative reviewed a proposed second settlement agreement of the dispute between the various beneficiaries ("Proposed Second Agreement"). The date of the Proposed Second Agreement reviewed by Respondent's designated representative is June 11, 1990.

UU. With respect to the Proposed Second Agreement, Respondent's duly authorized representative accurately acknowledges (again the report which

---

[1] While Petitioner does not agree with Respondent's Estate and Gift Tax Examiner on this one point, in fairness to the Court and Respondent, Petitioner notes that although Respondent's Examiner would allow the charitable deduction, he would also limit the amount of that deduction to the lesser of the amount received pursuant to the Agreement or the amount to which, according to Respondent but not the Georgia attorney general, the trust would have been entitled under Decedent's 1982 Will and Codicils ("being 52.95% of the net probate residue remaining after distribution of the four parcels of real property to the children.")

served as the basis for the Notice) that if properly executed, the Proposed Second Agreement would:

(i) Constitute a *bona fide* good faith settlement;

(ii) Between adverse, arm's length parties;

(iii) Of a legitimate challenge to a charitable interest

VV. Petitioner properly and correctly reported in Decedents' gross estate on the Estate Tax Return all items required to be included in the Estate Tax Return; the value at which each item of property is included in the gross estate of the tax return is the correct and accurate value of such property.

WW. Subsequent to filing the Estate Tax Return, Petitioner has paid or incurred attorneys fees, accounting expenses, and fees and other expenses of administration which constitute deductions from the Decedent's gross estate in computing any Federal estate tax deficiency, liability or overpayment of the Petitioner and the Petitioner is entitled to a deduction for such expenses it has paid or incurred.

XX. Petitioner will continue to pay or incur attorneys fees, accounting expenses, litigation and other expenses of administration (including, without limitation, the credit for State death taxes) in contesting the Respondent's erroneous determination of deficiencies in estate taxes and in concluding the administration of the estate, and Petitioner is entitled to a deduction for such expenses in computing the amount of any deficiency, liability or overpayment of Federal estate taxes.

YY. As a result of the foregoing, there is no deficiency in tax with respect to the Form 706, United State Estate Tax Return, filed by Petitioner in the Estate of Otis C. Hubert.

6. Based upon added costs of administration and other deductible expenses, Petitioner is entitled to a refund, with interest, of overpaid Federal estate taxes in an amount that cannot yet be stated with precision.

WHEREFORE, Petitioner prays that after due proceedings it be determined that there is no deficiency in estate tax, that Petitioner is entitled to a refund of Federal estate taxes overpaid which result from the additional deductions to which Petitioner is entitled and which have not been deducted in the Estate Tax Return and for such other and further relief as the Court deems appropriate.

Respectfully submitted,

/s/ David D. Aughtry
DAVID D. AUGHTRY
Tax Court Number AD0165

/s/ James M. McCarten
JAMES M. MCCARTEN
Tax Court Number MJ1850

CHAMBERLAIN, HRDLICKA,
WHITE, JOHNSON & WILLIAMS
1400 Harris Tower
233 Peachtree Street, N.E.
Atlanta, Georgia 30303
(404) 659-1410

EXHIBIT A

Internal Revenue Service
District Director

Department of the Treasury

Date: Aug. 31, 1990

Estate of Otis C. Hubert,
Deceased
Citizens & Southern Trust
Co., Executor
Post Office Box 12448
Atlanta, GA 30355

SSN: 252-05-1011V

Contact: Notices Clerk

Phone: 404-331-6121

CERTIFIED MAIL

Dear Executor:

In accordance with the provisions of existing internal revenue laws notice is hereby given that the determination of the estate tax liability of the Estate of Otis C. Hubert, Deceased, who died June 2, 1986, discloses a deficiency of $14,052,146.00. The basis of our determination and a computation of the deficiency are presented in the attached statement.

If you want to contest this determination in court before making any payment, you have 90 days from the above mailing date of this letter to file a petition with the United States Tax Court for a redetermination of the amount of your tax. The petition should be filed with the United States Tax Court, 400 Second Street NW, Washington, D.C., 20217, and the copy of this letter should be attached to the petition. The time in which you must file a petition with the court (90 days) is fixed by law and *the Court cannot consider your case if your petition is filed late.*

If you decide not to file a petition with the Tax Court, we would appreciate it if you would sign and return the enclosed waiver form. This will permit us to charge your account quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience. If you decide not to sign and return the statement and you

do not timely petition the Tax Court, the law requires us to bill you after 90 days from the mailing date of this letter.

If you have questions about this letter, please write to the person whose name and address are shown on this letter. If you write, please attach this letter to help identify your account. Keep the copy for your records. Also, please include your telephone number and the most convenient time for us to call if we need additional information. If you prefer, you may call the IRS contact person at the telephone number shown above. Thank you for your cooperation.

Sincerely yours,

FRED T. GOLDBERG, JR.
Commissioner
By

/s/ [Illigible]
District Direcotr

/s/ WIC

Enc: Copy of this letter
Statement
Waiver (Form 4089)
Envelope

401 West Peachtree Street NW, Atlanta, Georgia, 30365

Aug. 31, 1990

FORM 4089
NOTICE OF DEFICIENCY—WAIVER

Estate of Otis C. Hubert, Deceased
Citizens & Southern Trust Co., Executor
Post Office Box 12448
Atlanta, GA 30355

SSN: 252-05-1011V

Kind of tax: ESTATE Date of Death: June 2, 1986

DEFICIENCY: $14,052,146.00

See the attached explanation for the above deficiency.

The above deficiency of federal estate tax will be assessed either when the taxpayer's written agreement to the deficiency (Form 4089) is received or upon the expiration of 30 days from the date of this notice if a petition is not filed with the United States Tax Court.

If evidence of payment of additional state death tax is filed with this office within 90 days of this letter an additional credit in the amount noted in the attached computation (Form 3614A) will be allowed as a reduction of the estate tax liability and the assessment of the deficiency will be limited accordingly.

I consent to the immediate assessment and collection of the deficiencies (increase in tax and penalties) shown above, plus any interest provided by law.

AUTHORIZED SIGNATURE ———— Date: ——

———— Date: ——

NOTE: If you consent to the assessment of the amounts shown in this waiver, please sign and return it in order to limit the accumulation of interest and expedite our bill to you. Your consent will not prevent you from filing a claim for refund (after you have paid the tax) if you later believe you are entitled to a refund. It will not prevent us from later determining, if necessary, that you owe additional tax; nor will it extend the time provided by law for either action. If you later file a claim and the Internal Revenue Service disallows it, you may file suit for refund in a district court or in the United States Claims Court, but you may not file a petition with the United States Tax Court.

WHO MUST SIGN: A person acting in a fiduciary capacity (executor, administrator, trustee), must file Form 56, Notice Concerning Fiduciary Relationship, with this form if not previously filed. For an agent or attorney acting under a power of attorney, a power of attorney must be sent with this form if not previously filed.

IF YOU AGREE, PLEASE SIGN ONE COPY AND RETURN IT; KEEP THE OTHER COPY FOR YOUR RECORDS.

CC: David D. Aughtry, 233 Peachtree St., NE, 1400 Harris Tower, Atlanta, GA. 30303

Form 3614-A
COMPUTATION OF ESTATE TAX

Estate of Otis C. Hubert, Deceased
SSN: 252-05-1011V
D/D: June 2, 1986

Taxable Estate Plus Adjusted Taxable Gifts as shown in Return as Filed	**$ 1,516,624.00**
Increases (Decreases) to Taxable Estate plus Adjusted Taxable Gifts:	
(a) Adjusted Taxable Gifts	**9,202.00**
(b) Schedule K—Debts of the Decedent	**344,959.00**
(c) Schedule M—Marital Deduction	**12,650,592.00**
(d) Schedule O—Charitable Deduction	**200,000.00**
(e) Schedule O—Charitable Deduction	**12,502,655.00**
Taxable Estate plus Adjusted Taxable Gifts as Revised	**$27,224,032.00**
1. Tentative Tax	**$14,614,018.00**
2. Aggregate gift taxes payable (After 12/31/86)	**7,481.00**
3. Line 1 — line 2 =	**$14,606,537.00**
4. Unified Credit against estate tax	**$ 155,800.00**
5. Adjustment to unified credit	**—0—**
6. Allowable unified credit (line 4 — line 5 =)	**$ 155,800.00**
7. Line 3 — line 6 =	**$14,450,737.00**
8. Credit for state death taxes substantiated	**54,163.00**
9. Line 7 — line 8 =	**$14,396,574.00**
10. Other credits	**—0—**
11. Net estate tax	**$14,396,574.00**
12. Estate tax assessed	**344,428.00**
13. Increase in tax	**$14,052,146.00**
14. Less: Additional credit for state death taxes allowable, if substantiated:	**3,742,280.00**
15. Increase	**$10,309,866.00**

Estate of Otis C. Hubert, Deceased
Marietta, GA

Statutory Notice
Statement

Explanation of Adjustments

(a) It is determined that the adjusted taxable gifts of the decedent total $163,763.00, rather than $154,561.00, as returned. This adjustment reflects inclusion of the $9,202.00 in taxable gifts of the donor for the period ending December 31, 1980, which were excluded from the adjusted taxable gifts as reported on Line 4 of page 1 of the Federal Estate Tax Return.

Accordingly, the taxable estate is increased $9,202.00.

(b) It is determined that the reduction of the gross estate for the debts of the decedent reported in Schedule K should be in the amount of $939,656.00, the correct total of the items reported, rather than $1,284,615.00, the amount incorrectly reported for these items.

Accordingly, the taxable estate is increased $344,959.00.

(c) It is determined that the gross estate should not be reduced by the reported value ($12,650,592.00) of the property interests identified at Item 7 of Schedule M. The interest of the surviving spouse in such property is determined to be a terminable interest which does not qualify for a marital deduction. It is further determined that such interest is not a qualified terminable interest for which a marital deduction would be allowable.

Accordingly, the taxable estate is increased $12,650,592.00.

(d) It is determined that the gross estate should not be reduced by the $100,000.00 reported for each of the

trusts identified at Items 1 and 2 of Schedule O. The interest passing under each of these trust is determined not to be exclusively for charitable purposes, therefore neither of the trusts qualify for a charitable deduction.

Accordingly, the taxable estate is increased $200,000.00.

(e) It is determined that the gross estate should not be reduced by the $12,502,655.00 reported for the O.C. Hubert Charitable Trust identified at Item 6 of Schedule O. The interest passing under the O.C. Hubert Charitable Trust is determined not to be exclusively for charitable purposes, therefore does not qualify for a charitable deduction. It is further determined that such trust does not meet any of the exceptions which would permit the allowance of a charitable deduction for the property interest passing under the O.C. Hubert Charitable Trust.

Accordingly, the taxable estate is increased $12,502,655.00.

UNITED STATES TAX COURT

Docket No. 22333-90
JUDGE CLAPP

ESTATE OF OTIS C. HUBERT, DECEASED, CITIZENS & SOUTHERN TRUST COMPANY (GEORGIA) N.A., a national banking association, Temporary Administrator and Nominated Co-Executor, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF FACTS

IT IS HEREBY STIPULATED that, for purposes of this case, the following statements may be accepted as true, except as qualified herein, and all exhibits referred to herein and attached hereto, are incorporated in this stipulation and made a part thereof. Either party may introduce other and further evidence not inconsistent with the facts herein stipulated or the contents of the exhibits.

1. Otis C. Hubert ("Mr. Hubert"), a resident of the city of Marietta, Cobb County, Georgia, died on June 2, 1986.

2. The estate of O.C. Hubert ("Estate") mailed a federal estate tax return (Form 706) on September 2, 1987, received by Respondent on September 9, 1987, a true and correct copy of which is attached as Joint Exhibit 1-A. Attached as an appendix to Joint Exhibit 1-A is a true and correct copy of the Agreement of Interested Parties addressed in paragraph 23 of this Stipulation. The Estate also filed federal income tax returns for the taxable years ended May 31, 1987, 1988, 1989, and

1990, true and correct copies of which are attached respectively as Joint Exhibits 2-B,, 3-C, 4-D, and 5-E.

3. On August 31, 1990, Respondent issued a notice of deficiency ("Notice") to the Estate asserting a gross deficiency in estate tax in the amount of $14,052,146 before consideration of any state death tax credits. A true and correct copy of the Notice is attached as Joint Exhibit 6-F.

4. The Notice raises the following adjustments:

a. Adjusted taxable gifts of the decedent total $163,763, rather than $154,561 as reported on the Form 706.

b. Deduction claimed for debts of the decedent as reported by schedule K of the Form 706 were reduced $344,959 to reflect a mathematical error.

c. Marital deduction, item 7 of schedule M of the Form 706 in the amount of $12,650,592 was not allowed because the interest of the surviving spouse was deemed a terminable interest by Respondent.

d. Charitable deductions for two trusts, items 1 and 2 of schedule O of the Form 706, each in the amount of $100,000 each were deemed not to be exclusively for charitable purposes.

e. Charitable deduction for the O.C. Hubert Charitable trust, item 6 of schedule O of the Form 706, in the amount of $12,502,655 was not deemed to be exclusively for charitable purposes and therefore, does not qualify for a charitable deduction.

5. On October 10, 1990, subsequent to the issuance of the Notice, a will contest was finally settled between the members of Mr: Hubert's family, Robert H. Owen, and the charitable beneficiaries represented by the Attorney

General for the State of Georgia. This settlement was reduced to writing in the form of the Second and Final Settlement Agreement of Interested Parties ("Second and Final Settlement Agreement") which was, in turn, incorporated into an Order, Judgment and Decree on October 11, 1990 by the Superior Court of Cobb County, Georgia. This Order, Judgment and Decree was then adopted by the Probate Court of Cobb County on November 28, 1990 which had at all relevant times jurisdiction over the probate of the Estate. A true and correct copy of the Second and Final Settlement Agreement is attached as Joint Exhibit 7-G.

6. Respondent does not dispute that the Second and Final Settlement Agreement is a good faith compromise of a *bona fide* will contest.

7. Prior to executing his 1982 Will, Mr. Hubert executed a Last Will and Testament on December 2, 1975 ("1975 Will"); superseded by a new will executed on August 5, 1977 ("First 1977 Will"), and another will executed on November 7, 1977 ("Second 1977 Will"). The 1975 Will, the First 1977 Will, and the Second 1977 Will all provided for substantial charitable bequests and a general power of appointment vested in his wife, Ruth S. Hubert ("Mrs. Hubert"). True and Correct copies of these documents are attached as exhibits to the Second and Final Settlement Agreement (Joint Exhibit 7-G).

8. On January 9, 1982, Mr. Hubert executed the last will to be signed prior to his death ("1982 Will"). A true and correct of the 1982 Will is attached hereto as Joint Exhibit 8-H.

9. Mr. Hubert executed three Codicils to his 1982 Will on February 4, 1982, February 19, 1982, and June 8, 1983. Attached hereto as Exhibits 9-I, 10-J, and 11-K, respectively, are true and correct copies of the three Codicils to the 1982 Will. The 1982 Will and three Codicils, as modified by the Second and Final Settlement Agreement, revokes all prior wills and codicils.

10. Robert H. Owen, nephew of Mr. Hubert, drafted the 1982 Will and three Codicils.

11. Mr. and Mrs. Hubert have four children, Richard N. Hubert ("Richard"), Marilyn Hubert Kemper ("Marilyn"), Judith Hubert Manning ("Judith"), and Deborah Hubert Jones ("Deborah"), the children and Mrs. Hubert being sometimes collectively referred to herein as the "Hubert Family".

12. On July 3, 1986, Citizens and Southern Trust Company (Georgia), N.A. ("C&S"), successor by affiliate transfer to The Citizens and Southern National Bank, filed a petition with the Probate Court of Cobb County to probate the 1982 Will and its three Codicils in common form, there being no similar application by the other Co-Executor, Mrs. Hubert. This petition was ultimately rescinded.

13. On July 16, 1986, Letters Testamentary in common form were issued to C&S.

14. On July 17, 1986, a Decision Order was entered by the Probate Court of Cobb County revoking and rescinding the Letters Testamentary issued to C&S and ordering that probate of the estate of O. C. Hubert remain pending in said Court.

15. On July 18, 1986, as a result of a dispute between Mr. Owen and the Hubert Family, Mr. Owen filed, in his role as successor Co-Executor and as a creditor of the Estate, a petition with the Cobb County Probate Court to probate in common form the 1982 Will and its three Codicils he had drawn. This petition was ultimately withdrawn on October 3, 1986.

16. On August 14, 1986, Mrs. Hubert filed an action with the Cobb County Probate Court challenging Mr. Owen's fitness to serve as a co-executor or trustee.

17. On August 15, 1986, C&S was appointed by the Cobb County Probate Court as temporary administrator for the Estate.

18. On August 17, 1986, Mr. Owen filed a Notice of Voluntary Dismissal Without Prejudice of Application

for Letters Testamentary Under the Last Will and Testament of Otis C. Hubert.

19. On October 3, 1986, the Probate Court of Cobb County entered an order allowing Mr. Owen to voluntarily dismiss his petitions to probate the 1982 Will and Codicils in common and solemn form.

20. On September 5, 1986, Mr. Owen filed a complaint with the U.S. Department of Labor under the Wage and Hour Law (29 U.S.C. Section 201, *et seq.*) against the Estate, its heirs at law and counsel. A true and correct copy of this complaint is attached as Joint Exhibit 12-L.

21. On November 6, 1986, Mrs. Hubert, as Co-Executrix and Trustee of the Hubert Estate, filed an action against Mr. Owen in Cobb County Superior Court seeking a declaratory judgment and equitable direction (captioned *Ruth S. Hubert v. Robert H. Owen*, Cobb County Superior Court Civil Action No. 86-1647399) and alleging that Mr. Owen was unqualified to serve as either co-executor or trustee and that he had abused the trust and confidence that Mr. Hubert had bestowed upon him.

22. On December 8, 1986, Mr. Owen filed an Answer and Counterclaim in *Ruth S. Hubert v. Robert H. Owen*, Cobb County Superior Court Civil Action No. 86-1647399. A true and correct copy of this Answer and Counterclaim is attached hereto as Joint Exhibit 13-M.

23. On June 24, 1987, a settlement agreement entitled "Agreement of Interested Parties", was entered into by and among Mrs. Hubert, Richard, Marilyn, Judith, and Deborah, Mr. Owen, and Thomas J. Charron, as District Attorney for Cobb County, Georgia. A true and correct copy of this agreement is attached as an appendix to Joint Exhibit 1-A.

24. The Agreement of Interested Parties purported to resolve all differences between the various beneficiaries, executors, and trustees.

25. On July 22, 1987, C&S filed a Petition for Declaratory Judgment and Equitable Direction in the Superior Court of Cobb County under the caption *Citizens and Southern Trust Company (Georgia), N.A., as Temporary Administrator of the Estate of Otis C. Hubert and nominated Co-Executor and Co-Trustee under the Last Will and Testament of Otis C. Hubert, deceased v. Ruth S. Hubert, Richard N. Hubert, Marilyn H. Kemper, Judith H. Manning, Deborah H. Jones, Robert H. Owen, Thomas Charron, as District Attorney for the Cobb Circuit, and Marcus E. Collins, Sr., as State Revenue Commissioner*, Civil Action File No. 87-14337622 and addressing the import of the Agreement of Interested Parties.

26. On August 4, 1987, Mrs. Hubert voluntarily dismissed, without prejudice, her action against Robert Owen in *Ruth S. Hubert v. Robert H. Owen*, Cobb County Superior Court Civil Action No. 86-1647399.

27. The Estate filed its United States Estate Tax Return (Joint Exhibit 1-A) based on the 1982 Will and Codicils and the Agreement of Interested Parties. For purposes of this proceeding, the parties agree that the Estate Tax Return accurately reported the Total Gross Estate (line 1 of Form 706) and the fair market value of the individual assets owned by Mr. Hubert at the date of his death.

28. On September 5, 1987, the Georgia Revenue Commissioner filed his Answer to the C&S Petition for Declaratory Judgment alleging, among other defenses, that the Agreement of Interested Parties was unfair to the charitable interests and that he was a necessary party who had not consented to the agreement.

29. On October 26 and 28, 1987, hearings were held on a Motion for Continuance filed by the Georgia Revenue Commissioner and on the Petition for Declaratory Judgment and Equitable Direction filed by C&S. The Superior Court denied the motion and accepted the Agreement of Interested Parties.

30. On December 7, 1987, the State Revenue Commissioner filed a Notice of Appeal with the Supreme Court for the State of Georgia.

31. On September 7, 1988, the Supreme Court issued its published opinion in *Collins v. Citizens & Southern Trust Co., et al.*, Supreme Court Case No. 45575.

32. On September 20, 1988, C&S filed a Motion for Reconsideration with the Supreme Court.

33. On November 10, 1988, the Supreme Court issued a revised opinion confirming the right of the State Revenue Commissioner, Marcus E. Collins, Sr., to inquire into and contest the first settlement agreement. *Collins v. Citizens & Southern Trust Co.*, 258 Ga. 665, 373 S.E.2d 612 (1988). A true and correct copy of this decision is attached hereto as Joint Exhibit 15-0.

34. From October of 1987 through September of 1990, extensive discovery was served, resisted, and taken among the parties to the action by C&S in the Superior Court of Cobb County and with respect to third party witnesses.

35. The controversy and litigation pertaining to the Estate of O. C. Hubert among Mrs. Hubert and her children on one side, other relatives of Mr. Hubert, and the charitable beneficiaries as represented by the State Revenue Commissioner of Georgia and the Attorney General of the State of Georgia went on from July of 1986 through October of 1990.

36. Pursuant to negotiations, the Second and Final Settlement Agreement was entered into on October 10, 1990. A true and correct copy of the Second and Final Settlement Agreement is attached hereto and previously identified as Joint Exhibit 7-G.

37. On October 11, 1990, the Probate Court of Cobb County entered an order authorizing C&S to compromise the claims of Mr. Owen against the Estate of O.C. Hubert for a payment of $150,000 in addition to the $16,000 which had already been paid.

38. On October 11, 1990, the Superior Court of Cobb County entered an Order, Judgment and Decree.

39. The Order, Judgment and Decree recognized that there were genuine and material disputes between the parties and approved the Second and Final Settlement Agreement, and ordered the nominated executors and trustees to comply with the terms of the 1982 Will and codicils as modified by the Agreement.

40. On November 28, 1990, the Probate Court of Cobb County entered an order adopting the Order, Judgment and Decree of the Superior Court as a binding order and judgment in the Probate Court proceedings involving the Estate of O. C. Hubert. Consequently, the Second and Final Settlement Agreement (as modifying the 1982 Will and Codicils) controls the actual distribution of Mr. Hubert's Estate.

41. On November 28, 1990, the Probate Court of Cobb County issued Letters Testamentary to C&S and Richard N. Hubert as co-executors of the Estate of O. C. Hubert.

42. With respect to the Hubert Estate, the following is a list of certain events and their dates of occurrences:

Date	Description
4/1/90	Date on which income of the properties ultimately selected for the Marital Share became allocable to the Marital Share in accordance with Paragraph 10 a.(2) of the Second and Final Settlement Agreement.
10/10/90	Date of execution of the Second and Final Settlement Agreement.
10/10/90	Effective date on which all income and expenses of the Estate was separately allocated to the Marital Share and the Charitable Share.
11/1/90	Date on which C&S set up the Marital Share segregation account.

Date	Description
11/2/90	Date on which C&S commenced funding the Marital Share segregation account.
11/28/90	Date C&S and Richard Hubert are issued Letters Testamentary as Co-Executors of the Hubert Estate.
4/10/91	Date on which the division of properties between Marital Share and the Charitable Share is completed.
4/30/91	Date of First C&S report after completion of the division of properties.
9/26/91	Arbitrary date through which ongoing administrative expenses of the Estate have been computed.

43. The Second and Final Settlement Agreement incorporated a procedure at Paragraph 10 for division of the residuary estate between the marital and charitable shares. That division was negotiated between representatives for the Hubert Family and representatives for the charities from October, 1990 until April 10, 1991 when agreement was reached. The schedules of real property designations and values used by representatives for the family and representatives for the charities for purposes of the division are collectively attached hereto as Joint Exhibit 14-N.

44. The parties agree to the use of the following amounts applicable to certain subparagraphs of Paragraph 10 of the Second and Final Settlement Agreement in computing the Marital Share:

a. The starting point as set forth in Paragraph 10 a.(1) is $14,390,000.00;

b. The amount of the pre-agreement expense adjustment to be added to the Marital Share pursuant to Paragraph 10 a.(1) and 10 a.(1)(A) is

$3,482,260.59. This represents an increase for expenses previously charged to income. The amount of the pre-distribution/segregation expense adjustment to be subtracted from the Marital Share pursuant to Paragraph 10 a.(1)(A) is $3,299.087.27. This represents 48% of the total expenses incurred prior to the execution of the Agreement. The net of these two adjustments is an addition to the Marital Share of $183,173.32.

c. The amount of the advancements and distributions from the Estate of Mrs. Hubert to be subtracted from the Marital Share pursuant to Paragraph 10 a.(1)(B) is $1,219,602.62. This represents amounts distributed prior to the execution of the Agreement.

d. The amount of the increase to be added to the Marital Share pursuant to Paragraph 10 a.(2) representing the income earned on the assets selected by Mrs. Hubert for the GPA Trust and QTIP Marital Trust from April 1, 1990 to October 10, 1990, is $699,376.34.

45. The post-agreement administrative expenses incurred by the Marital Share were $398,269.37 through April 10, 1991, the date of the final division of the property. In addition, post-agreement administrative expenses have been incurred from April 10, 1991 through September 26, 1991 in the amount of $150,144.28. Additional administrative expenses will be incurred after September 26, 1991 in an undetermined amount. Of these expenses the amount of $350,000.00 has already been deducted on the Hubert Estate's original Form 706 as an estimate of the Executor's fees.

46. C&S valued the net undistributed real and personal property as of April 30, 1991, the date of the first statement for the Estate after the property division under the Second and Final Settlement Agreement was finalized,

at $32,095,354. During the course of selecting which properties would fund the Marital Share (with the remainder going to the Charitable Share) a representative for the Hubert Family and a representative for the charities used certain real property values that varied from the C&S values as follows:

Account Name	A/C #	Total C&S Values	Less C&S Real Property Values	Plus Real Property Division Amounts	Total Adjusted Property Division Amounts
Temp Adm. Est. of O.C. Hubert	154120	$17,943,551	$16,797,895	$13,993,150	$15,138,806
GPA Trust	154121	7,950,202	4,193,015	4,154,082	7,911,269
Deborah Jones	154122	784,016	702,000	702,000	784,016
Marilyn Kemper	154123	733,613	692,407	626,000	667,206
Richard Hubert	154124	1,197,976	1,350,000	1,350,000	1,197,976
Judy Manning	154125	2,371,836	2,118,935	2,110,000	2,362,901
Others assets not on C&S Report		1,114,160	0	0	1,114,160
(Primarily bonds in possession of Mrs. Hubert which are now in the possession of the Estate)					
TOTAL		$32,095,354	$25,854,252	$22,935,232	$29,176,334

47. The date of death value (June 2, 1986) of the real property owned by the Estate on April 10, 1991, as shown on the Hubert Estate's Form 706, was $22,481,350. Real properties of a date of death value of $1,394,725 were disposed of during the period from June 2, 1986 to April 10, 1991.

48. The testimony which would be given by William S. Saville, as Vice-President in the C&S Trust Department, if called as a witness at trial includes the statements set forth in his affidavit attached as Joint Exhibit 16-P. This affidavit is accepted as testimony for all purposes in this case.

49. The testimony which would be given by Aymar H. Manning, a real estate broker and a son-in-law of decedent, if called as a witness in this case includes the statements set forth in his affidavit attached as Joint Exhibit 17-Q. This affidavit is accepted as testimony for all purposes in this case.

50. The gross estate and specific bequests based upon date of death values are as follows:

CALCULATION OF FORM 706 GROSS RESIDUE
BASED ON DATE OF DEATH VALUES

GROSS ESTATE	$30,254,219
SPECIFIC BEQUESTS	
SPOUSE	$ (220,747)
CHURCHES	$ (400,000)
OTHERS	$ (30,000)

51. The parties agree that all of the Hubert Family signatories to the Second and Final Settlement Agreement would testify that they intended to enlarge, not reduce, the estate passing to the beneficiaries. Further, they would also testify that they understood Mr. Hubert's intention to be the same.

52. On September 28, 1989, James E. Hicks filed a lawsuit against the Citizens and Southern National Bank, (as the temporary administrator of the estate of Mr. Hubert) and Richard N. Hubert in the Superior Court of

Cobb County, State of Georgia, Civil Action No. 8916644-04. The case remains pending.

53. In his complaint, Plaintiff James E. Hicks asked for a judgment against the Estate of Mr. Hubert in the amount of $352,00.00, plus interest, attorney's fees and punitive damages in an unspecified amount pursuant to the alleged breach of an employment contract between Mr. Hicks and Mr. Hubert. True and correct copies of the complaint and the employment contract are attached as Joint Exhibits 18-R and 19-S.

54. Attached as Joint Exhibit 20-T is a true and correct copy of a letter from Eastham and Grate, attorneys for Plaintiff James E. Hicks, in said action, setting forth Plaintiff's settlement demand.

55. The parties agree that the following additional claims are allowed as a claim or debt of the Estate for Estate Tax purposes:

Claimant	Amount
Owen, Robert	$166,000
Foster, Trustee	$ 6,500
Safeco Title Co.	$ 33,333

The parties further agree that the claim of James E. Hicks will be allowed as a claim against the Estate in the amount of $166,000 unless said claim is disposed of for a lesser amount prior to the termination of this case, in which event it shall be allowed in such lesser amount.

The parties agree to these amounts because of minimal impact on the Estate without taking into consideration the date of death value of the claims.

56. Attached are true and correct copies of certain documents relating to the probate of Mr. Hubert's will:

a. Attached as Joint Exhibit 21-U is a true and correct copy of Letters Testamentary issued to the Citizens & Southern National Bank in common form, dated July 16, 1986.

b. Attached as Joint Exhibit 22-V is a true and correct copy of an Order of the Probate Court of Cobb Cunty, dated July 17, 1986, in the Estate of O.C. Hubert rescinding the probate in common form and the Letters Testamentary issued to Citizens & Southern National Bank.

c. Attached as Joint Exhibit 23-W is a true and correct copy of an Order dated August 15, 1986 appointing the Citizens & Southern National Bank as Temporary Administrator of the Estate of O.C. Hubert.

d. Attached as Joint Exhibit 24-X is a true and correct copy of the Petition to Probate Will in Solemn Form in the Estate of O.C. Hubert, filed by the Citizens & Southern Trust Company (Georgia) N.A. with the Probate Court of Cobb County, State of Georgia on June 1, 1990.

e. Attached as Joint Exhibit 25-Y are true and correct copies of Caveats filed by Mr. Hubert's wife, Ruth S. Hubert, in the Probate Court of Cobb County, Georgia, in the Estate of O.C. Hubert on August 14, 1986, and June 26, 1990.

f. Attached as Joint Exhibit 26-Z is a true and correct copy of a Caveat filed by Mr. Hubert's daughter Deborah Hubert Jones, in the Probate Court of Cobb County, Georgia, in the Estate of O. C. Hubert on August 22, 1986.

g. Attached as Joint Exhibit 27-AA is a true and correct copy of a Caveat filed by Mr. Hubert's daughters Judith Manning and Marilyn Kemper in the Probate Court of Cobb County, Georgia, in the Estate of O. C. Hubert on August 29, 1986.

h. Attached as Joint Exhibit 28-AB is a true and correct copy of a Caveat filed by Mr. Hubert's three daughters in the Probate Court of Cobb

County, Georgia, in the Estate of O. C. Hubert on or about June 11, 1990.

l. Attached as Joint Exhibit 29-AC is a true and correct copy of Letters Testamentary issued in solemn form to Citizens & Southern Trust Company (Georgia) N.A. and Richard N. Hubert as Co-Executors of the Estate of O.C. Hubert, dated November 28, 1990.

57. With respect to the Marital deduction attributable to the residuary estate, the position of the parties as to the amount of residuary corpus actually passing to Mrs. Hubert is as follows:

SECOND AND FINAL SETTLEMENT	PETITIONER	RESPONDENT
Para. 10 a. (1)	$ $14,390,000	$14,390,000
Para. 10 a. (1) and 17 (a) $3,482,262 ($3,299,087)	$ 183,175	$ 183,175
Para. 10 a. (2)	$ 699,376	$ 699,376
Subtotal Marital	$15,272,551	$15,272,551
DIFFERENCES		
Para. 10 a. (1) (B) (Mar. Inc.)	($ 1,219,603)	
10 a. (2) (Mar. Inc.)	($ 699,376)	
Implicit Interest Income (7% from 6/2/87 to 10/10/90)		($ 2,847,541)
Para. 10 f. (3) Post-Agmt. Post Agmt. Inc. ($608,311 through 4/10/91)	No Effect on M.D.	—0—
Post Agmt. Exp. $548,413 through 9/26/91; $398,269 through 4/10/91)	No Effect on M.D.	($ 548,413)
Allowable Resid. Mar. Ded.	$13,353,572	$11,896,597*

* Respondent contends this amount is further reduced by 48% of any estate taxes and interest due pursuant to Paragraph 10 c. and d. of the Second and Final Settlement Agreement and that the Estate's marital deduction is further limited to the actuarial value of the property passing to the spouse under decedent's will and codicils.

58. With respect to the charitable deduction attributable to the residuary estate, Petitioner contends that, under Paragraph 10 e. of the Second and Final Settlement Agreement, the remainder of the residuary corpus and income is to be paid over to the charitable trust and that Petitioner is entitled to a charitable deduction of that remainder for Federal Estate tax purposes as follows (based on the assumption that the date of death residuary is $26,224,436 and the corpus allocated to the marital share is $13,353,572):

Date of Death Residuary—Corpus	$26,224,436
Allocated to Marital—Corpus	(13,353,572)
Balance to Charity—Corpus	$12,870,864

Respondent contends that, under Paragraph 10 of the Second and Final Settlement Agreement, the remainder of the residuary corpus and income is to be paid over to the charitable trust and that the amount of property actually passing to the charities from the residuary estate is as follows:

Adjusted Value as of 4/30/91 (ref. Stip. ¶ 46)	$29,176,334
Previously Distributed Inc.	$ 1,219,603
Marital Share before Implicit Int. Inc. and Post Agmt. Expenses	($15,272,551)
Share of Unpaid Post Agmt. Admin. Exp.	($ 185,000)
Subtotal Charitable	$14,938,386
Less Implicit Int. Inc. (7% per annum) from 6/2/87 to 10/10/90	($ 3,098,001)
Charitable Deduction Per Resp.	$11,840,385**

** Respondent contends this amount is further reduced by 52% of any estate tax and interest due pursuant to Paragraph 10 c. and d. of the Second and Final Settlement Agreement and that the Estate's charitable deduction is limited further to the actuarial value of the property passing to the charities under decedent's will and codicils.

Petitioner maintains with respect to Respondent's calculation of the charitable deduction (a) that the proper starting number is the C&S value as of 4/30/91 of $32,095,354 rather than $29,176,334; (b) that the administrative expenses are payable out of income and do not reduce the residuary corpus passing to the Charitable Trust; and (c) that the Estate has already dealt with the actual income passing to the Charitable Share as indicated on the Forms 1041.

59. Respondent contends that the actuarial value of the life estate and the charitable remainder interest bequeathed in decedent's Will is calculated according to Treas. Reg. § 20.2031-7.

60. The parties agree that some portion paid to or on behalf of Mrs. Hubert by the Estate, is an amount representing income to Mrs. Hubert.

61. The amount and deductibility of litigation fees incurred by the Estate will be determined under Rule 155 or subsequent proceeding. The effect which these fees may have on the marital and charitable deductions, if any, is also reserved for this proceeding.

62. The parties disagree as to whether $200,000 of the specific bequests included in the charitable bequest by Petitioner is deductible. This is a separate and unresolved issue.

63. When Mr. Hubert first moved to Atlanta in 1928, he joined the Baptist Tabernacle Church in the inner city area. He continued to attend the Baptist Tabernacle until 1952, when he moved from the downtown area to Marietta outside of Atlanta.

64. From that time to his death, he regularly attended the First Baptist Church of Marietta rather than the Baptist Tabernacle.

65. In one instance, he and a man by the name of John Nance were asked to sponsor two missionaries from the church, Roland Cornelius and Redford Trammel, who the Baptist Tabernacle could not otherwise finance.

66. Mr. Hubert had no relationship with them other than through the Baptist Tabernacle.

67. Mr. Hubert and Mr. Nance agreed to sponsor them and did so through the Baptist Tabernacle for a number of years until Mr. Nance was no longer able. At that time, Mr. Hubert assumed Mr. Nance's share of the responsibility.

68. Mr. Trammell is an independent Baptist Missionary, commissioned by North Avenue (now Park View Baptist Church), Northlake, Illinois and supported by several churches and individuals. He is presently a member of Calvary Baptist Church, Sparta, Tennessee. Mr. and Mrs. Hubert were members of a Baptist Church in Georgia at the same time that he was a member of a Baptist Church in South Carolina in January 1982.

69. Mr. Trammell's birthdate is June 28, 1931.

70. Mr. Trammell entered foreign missionary work in September 1960 when he arrived in Peru.

71. Except for furloughs in the United States Mr. Trammell has been working continuously in Peru helping Peruvians start Baptist churches. So far he has been able to start fifteen churches, most of which have their own pastors and buildings.

72. Mr. Trammell has not made any specific agreement with any church or other organization concerning the distribution of the funds designated to his work by Mr. Hubert.

73. At the time the Will was drawn (January 1982), Reverend Roland Cornelius was affiliated with Baptist International Missions, Inc. ("BIMI") which has a home office in Chattanooga. The Baptist Tabernacle of Atlanta is a supporter of that organization. He met Mr. O.C. Hubert as a youth when Mr. Hubert taught him Sunday School at the Baptist Tabernacle of Atlanta.

74. His birthdate is March 12, 1933. His age at the time of the Will was 48.

75. He entered missionary work in 1956.

76. Generally, his and his wife's work has always been missionary radio. He spent 16 years in Africa, another 14 years with BIMI, part of which time he worked on a project called Lighthouse of the Caribbean, and thereafter and to date he has been associated with Aviation Radio Missionary Services, a tax exempt organization.

77. Mr. Hubert's date of birth was March 24, 1906.

78. Attached as Joint Exhibit 30-AD is a summary of the expenses paid by the Estate through October 10, 1990, used in the computation of the Marital Share pursuant to Paragraph 10 a.(1) of the Second and Final Settlement Agreement.

79. Attached as Joint Exhibit 31-AE is a summary of the administrative expenses paid by the Estate through October 10, 1990.

80. Attached as Joint Exhibit 32-AF is a summary of the administrative expenses for attorneys' fees, fiduciary fees and accounting fees paid by the Estate from October 10, 1990, to September 26, 1991.

81. Attached as Joint Exhibit 33-AG is a summary of the Marital Share portion of the administrative expenses for attorneys' fees, fiduciary fees and accounting fees paid by the Estate from October 10, 1990, to September 26, 1991, further broken down between those paid through April 10, 1991, and those paid after April 10, 1991.

82. The testimony which would be given by Catherine Lacienski, Chief of the Atlanta Appeals Audit Section, if called as a witness at trial, includes the statements set forth in her affidavit attached as Joint Exhibit 34-AH. Petitioner reserves the right to challenge her affidavit on the grounds of lack of competency.

ABRAHAM N.M. SHASHY, JR.
Chief Counsel
Internal Revenue Service

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DATED: December 17, 1991

STATE OF GEORGIA)
)
COUNTY OF FULTON)

AFFIDAVIT

PERSONALLY APPEARED before the undersigned officer duly authorized to administer oaths, WILLIAM S. SAVILLE, who, having been first duly sworn upon his oath, deposes and says as follows:

1. My name is William S. Saville and I am a Vice-President in the Trust Department of C&S/Sovran Trust Company [formerly Citizens & Southern National Bank of Georgia (N.A.)] (the "Bank").

2. O.C. Hubert (Mr. Hubert), a resident of the city of Marietta, Cobb County, Georgia, died on June 2, 1986.

3. The Bank was named as one of the two co-executors in the Last Will and Testament of O.C. Hubert dated January 7, 1982 ("1982 Will"). Furthermore, when a will contest arose, the Bank was named as Temporary Administrator and then as a co-executor once the will contest was resolved.

4. Mr. Hubert was survived by his wife, Ruth S. Hubert ("Mrs. Hubert") and their four children: Richard N. Hubert, Marilyn Hubert Kemper, Judith Hubert Manning, and Deborah Hubert Jones, the children and Mrs. Hubert being sometimes collectively referred to herein as the "Hubert Family".

5. Immediately after Mr. Hubert's death, I was assigned responsibility for handling the Hubert Estate for the Bank and have continued to do so ever since.

6. The responsibilities of the Bank include acting on behalf of the Hubert Estate in all matters including filing returns, paying expenses, and overseeing all activity engaged in by the Estate.

7. In that regard, the Estate filed its Federal Estate Tax Return (Form 706) on September 2, 1987. The

Estate also filed Federal Fiduciary Income Tax Returns (Form 1041).

8. The 1982 Will provided for a series of specific bequests with the majority of the Estate passing by way of a residuary trust giving Mrs. Hubert all the income for life and a testamentary general power of appointment over all of the remainder. Absent the exercise of that general power of appointment, the remainder went over to a charitable trust for the sick, starving, and those who need Bibles.

9. The 1982 Will was amended by three codicils drafted by Mr. Robert H. Owen and executed by Mr. Hubert. The second codicil ("Second Codicil to 1982 Will") purported to repeal the general power of appointment in favor of Mrs. Hubert.

10. Mrs. Hubert's daughters filed caveats contesting the 1982 Will and Codicils on, among other grounds, that Mr. Owen had exercised undue influence over Mr. Hubert and defrauded Mrs. Hubert out of her rights under the general power of appointment.

11. That dispute was ultimately purportedly resolved by a document captioned "Agreement of Interested Parties" (also referred to herein as "First Settlement").

12. This agreement was executed by Mr. Owen, the Hubert Family, and the District Attorney for Cobb County, Georgia on behalf of the charitable interests.

13. The Georgia Revenue Commissioner, on behalf of the charitable interests and through the Attorney General of the State of Georgia, challenged the First Settlement.

14. From September of 1987 through October of 1990, litigation with the State of Georgia ensued from the Probate Court of Cobb County through the Cobb County Superior Court to the Georgia Supreme Court and back.

15. After approximately three years of negotiation, the litigants entered into a settlement captioned "Second and Final Settlement Agreement of Interested Persons Regarding the Estate of O.C. Hubert" ("Second and Final Settlement Agreement").

16. The Second and Final Settlement Agreement provided, among other terms, for payment of the claim lodged by Mr. Owen and for division of the residuary estate, subject to designation of the individual tracts of real estate, as follows:

a. The Marital Share is to receive $14,390,000 subject to various adjustments;

b. One of these adjustments is a credit of the income previously paid to or for, and reported by, Mrs. Hubert in the amount of $1,219,602.62; and

c. The remainder of the residuary is to pass to the Charitable Trust for the sick, starving, and those who need Bibles.

17. A segregation account for the Marital Share was set up on the books of the Hubert Estate commencing November 1, 1990, the first day of the first month following the date of the Second and Final Settlement Agreement, to segregate the Marital Share from the remainder of the Estate.

18. On November 2, 1990, the Hubert Estate commenced funding the Marital Share segregation account.

19. C&S, as Co-Executor, considered the segregation of the assets to take place as of October 10, 1990, the date of the Second and Final Settlement Agreement, because said Agreement required the actual income and expenses of the properties to be allocated from that date forward between the segregated Marital Share and the segregated Charitable Share depending upon which properties went to each share.

20. In accordance with Paragraph 10 of the Second and Final Settlement Agreement, the Marital Share to be distributed to the GPA Marital Trust and the QTIP Marital Trust totaled $14,052,947.04 as of the date of the agreement, the Marital Share amount was computed in

accordance with Paragraph 10 of the Second and Final Settlement Agreement as follows:

(a) C&S began with the initial amount as set forth in Section 10(a)(1) of $14,390,000;

(b) To that amount was added the pre-agreement expense adjustment pursuant to Paragraph 10(a)(1) and 10(a)(1)(A) which amount was $183,174;

(c) From that amount was subtracted the income distributions from the Estate to Mrs. Hubert pursuant to Paragraph 10(a)(1)(B) which amount was $1,219,603;

(d) To that amount was added the income on the assets selected by Mrs. Hubert for the GPA Trust and the QTIP Marital Trust from April 1, 1990, to the date of the Second and Final Settlement Agreement pursuant to Paragraph 10(a)(2) which amount was $699,376.34; and

(e) No amount was subtracted to reflect the administrative expenses after the date of the Second and Final Settlement Agreement because it is anticipated that the off-setting adjustments of income and expenses under Paragraph 10(f)(3) will yield an ongoing net future entitlement to the Marital Share (that is, income in excess of expenses). All the administrative expenses incurred after the date of the Agreement have either been deducted on the Form 706 (thus already reducing the amount of the residuary eligible for the marital and charitable deductions) or it is contemplated that they will be deducted on the Forms 1041 of the Estate to be filed.

21. The post-agreement administrative expenses incurred by the Marital Share have been $398,269.37 through April 10, 1991, and $548,413.65 through September 26, 1991. Of these expenses the amount of $350,000.00 has already been deducted on the Hubert Estate's original Form 706. The prorated post-agreement

income was $608,311 through April 10, 1991, and $1,173,1710 through September 26, 1991.

22. The residuary estate based upon date of death values is $26,224,436 calculated as follows:

CALCULATION OF FORM 706 GROSS RESIDUE BASED ON DATE OF DEATH VALUES

GROSS ESTATE	$30,254,219
SPECIFIC BEQUESTS	
SPOUSE	$ (220,747)
CHURCHES	$ (400,000)
OTHERS	$ (30,000)
SCHEDULE J DEDUCTIONS PER RETURN	$ (506,989)
SCHEDULE K DEDUCTIONS	$(2,472,047)*
ESTATE TAX	$ (400,000)
TOTAL RESIDUARY ESTATE	$26,224,436

* This does not include the claim of James E. Hicks, the deductibility of which is at issue in this case.

23. The Second and Final Settlement Agreement provided for payment to the Charitable Share of the remainder of the residuary estate after payment of the Marital Share (and the specific bequests) to be distributed to a charitable trust.

24. Item XIX of the 1982 Will granted the executors the power to charge expenses against principal or income. Item XIX also directed us to make any elections for tax purposes in the best interests of the beneficiaries. Items XIX and XXI of the Will also indicated that Mr. Hubert's intent was to maximize the marital and charitable deductions in order to maximize the amount passing to the beneficiaries.

25. Based upon these considerations in the Will, the Estate allocated administrative expenses between the income and corpus interests on the Federal Estate Tax and Fiduciary Income Tax Returns as follows:

Expense	(Form 706)	(Form 1041: 5/31/87 thru 5/31/90)
C&S Fees	$350,000	$371,696
Appraisals	$90,000	94,844
Legal	40,000	991,905
Acctng.	20,000	—

26. Pursuant to the first C&S report (as of April 30, 1991) folowing the division of the properties between the Marital Share and the Charitable Share on April 10, 1991, C&S valued the undistributed real and personal property of the Hubert Estate at $32,095,354. This was made up of the following accounts:

Account Name	A/C#	Total C&S Amount
Temp Adm. Est. of O.C. Hubert	154120	$17,943,551
GPA Trust	154121	7,950,202
Deborah Jones	154122	784,016
Marilyn Kemper	154123	733,613
Richard Hubert	154124	1,197,976
Judy Manning	154125	2,118,935
Other assets not on C&S report (Primarily bonds in possession of Mrs. Hubert which are now in the possession of the Estate)		1,114,160
TOTAL		$32,095,354

27. Through the date of the Second and Final Settlement Agreement of Interested Persons Regarding the Estate of O.C. Hubert (the "Agreement"), a true and correct copy of which is attached as Exhibit 10, the Estate distributed income to or for Mr. Hubert's widow, Mrs. Ruth S. Hubert, in the amount of $1,219,602.62.

28. This income was included in the total amount passing to the Marital Share under the Second and Final Settlement Agreement.

29. It has always been the belief of the Bank that Mr. Hubert's intent was to enlarge, not reduce, the estate passing to his beneficiaries.

30. The monthly report of C&S for the Hubert Estate for the month ended April 30, 1991, showed a net value of the assets of the Estate of $30,981,194.00. In addition, $1,114,160.00 of assets belonging to the Estate, which were in the possession of Mrs. Hubert and are now in the possession of the Estate, were not listed on the report. Accordingly, the total net value of the Estate at April 30, 1991, was $32,095,354.00.

31. As part of its duties first as temporary administrator and then as co-executor of the Hubert Estate, C&S adjusted the values of the properties to reflect information known to C&S.

32. On its reports, C&S adjusted the values of the properties to reflect any new appraisal that was obtained on a property, any increases in the property tax values above the value at which C&S was carrying a property, and any capital improvements on a property.

33. C&S was aware of the values recorded by the representatives of the Hubert family and the charities in making the division of properties pursuant to the Second and Final Settlement Agreement.

34. The difference between the C&S values and the values arrived at by the representatives of the Hubert family and the charitable interests for the properties going to the Marital Share was only $114,275.00.

35. Pursuant to Paragraph 10 of the Second and Final Settlement Agreement, the values of the Marital Share properties had to be computed in order to fund the amount of $14,052,947.00 determined to be going to the Marital Share pursuant to Paragraph 10.

36. C&S understood that it was unnecessary in the real property division process to value the properties going to the Charitable Share because pursuant to Paragraph 10 of the Second and Final Settlement Agreement, the Charitable Share received all the properties, regardless of their value, that were not selected to fund the Marital Share.

37. The difference between the C&S value for the properties going to the Charitable Share and the amount used by the representatives of the Hubert family and the Charitable Share with respect to such properties was $2,804,745.00.

38. In most instances, the representatives of the Hubert family and the Charitable Share assigned the date of death value to the properties going to the Charitable Share. These values failed to reflect capital improvements made to some of the properties and the substantial appreciation of a number of the properties.

39. By way of example, C&S increased the values of the following properties based upon appraisals obtained in 1989 and 1990 whereas no adjustment was made to the date of death values used in the real property division process:

706 Ref.	Description	706 Value	C&S Value 4/30/91	Division Value	Increase Per C&S Value
100	US 41 & Cobb Parkway	219,000	600,000	219,000	381,000
76	Andrews (Kemps & Cobb Pkwy)	729,000	1,500,000	729,600	770,400
78	17 ac. 41 @ Mars Hill	340,000	740,000	340,000	400,000
85	35 acres	3,692,000	3,980,000	3,692,000	288,000
31	Marble Mill	1,232,000	1,370,000	1,232,000	138,000
	TOTAL	6,212,600	8,190,000	6,212,600	1,977,400

40. Based on the foregoing facts, C&S believes that the values that it has used on its reports more accurately reflect the true value of the properties of the Estate than do the amounts assigned in dividing the residuary property of the Estate.

41. Our opinion remains that the valuation by C&S fairly reflects the fair market value of the real estate and

is far more accurate than the amounts assigned in the real property division process.

/s/ William S. Saville
WILLIAM S. SAVILLE

[Jurat Omitted in Printing]

UNITED STATES TAX COURT

Docket No. 22333-90
JUDGE CLAPP

ESTATE OF OTIS C. HERBERT, DECEASED, CITIZENS & SOUTHERN TRUST COMPANY (GEORGIA) N.A., a national banking association, Temporary Administrator and Nominated Co-Executor, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF AGREED ISSUES

IT IS HEREBY STIPULATED that, for purposes of this case, the parties shall be bound to the terms and conditions set forth below:

1. Respondent does not dispute that the Second Settlement Agreement modified the 1982 Will and three Codicils so that the split interest provisions under I.R.C. Section 2055(e) does not bar a deduction for the charitable gift and that the provisions of Section 2056(b)(7)(B)(III) (proper election of QTIP) does not bar a deduction for the marital gift.

The parties agree that the issues remaining with respect to the estate tax marital and charitable deductions are as follows:

a. *Marital Issues.*

(i) Whether the amount of the petitioner's marital deduction is limited to the lesser of: (1) the amount passing to the spouse under the 1982 Will and three codicils or (2) the amount actually passing to the spouse.

Petitioner asserts that there is no such limitation; and, even if there were such a limitation, that it would be mathematically irrelevant here.

Respondent asserts that there is a limitation.

(ii) Whether, under Section 2056(b)(4) the amount of residuary corpus passing to the Marital Share (pursuant to the 1982 Will and Codicils, as modified by the Second and Final Settlement Agreement) must be reduced by obligations charged to the Marital Share, without regard to (a) whether the Estate charged those expenses to income on the Forms 1041 and (b) whether there are offsetting income adjustments under the settlement.

Petitioner asserts first that the authority of this Court (in *Est. of Richardson, infra* and *Estate of Street, infra*) and Georgia law establish the right of an Estate to charge such expenses to income; secondly, the 1982 Will and Codicils, as modified by the Second and Final Settlement Agreement, permit, if not instruct, the Executors to pay such expenses out of income (i.e., any charge of these expenses to the Marital Share under the Settlement does not alter the ability to pay the expenses out of the income of the Marital Share); thirdly, any charge of post-agreement expenses to the Marital Share must be read in conjunction with the offsetting credits to the Marital Share for post-agreement income; and fourthly, the expenses in question are, by the terms of the Second and Final Settlement Agreement, limited to pre-segregation expenses which, for the most part, have already been deducted on the Form 706.

Respondent asserts that a reduction is necessary whether or not obligations are paid out of corpus.

(iii) What portion of the amount allocated to the spouse under the Second and Final settlement Agreement represents the portion of income earned by the marital interest during estate administration?

Petitioner asserts that the income element of the amounts passing to the marital share consists of the actual income previously distributed to Mrs. Hubert (addressed in Paragraph 10 a.(1)(B) of the Second and Final Settlement Agreement) plus the gap income addressed in Paragraph 10 a.(2). Petitioner further asserts that the Respondent's argument is the "discount theory" which Petitioner believes has been conceded and (as described in greater detail in support of Petitioner's Motion for Partial Summary Judgment) and has never been adopted by Congress in the estate tax area nor applied by Georgia law (specifically Official Code of Georgia Annotated § 53-2-97) to a will dispute.

Respondent asserts that the marital gift is a general bequest under O.C.G.A. § 53-2-97, entitled to 7% simple interest per year beginning one year after the date of death.

b. *Charitable Issues.*

(i) Whether Petitioner's charitable deduction is equal to the residue of the Estate as of the date of death less the portion of the residue representing corpus passing to the Marital Share pursuant to Paragraph 10 of the Second and Final Settlement Agreement.

Petitioner asserts that, under the Second and Final Settlement Agreement, any residuary corpus that does not go to the Marital Share necessarily goes to the Charitable Share. Petitioner further asserts that a finding in its favor on this issue renders all the following charitable issues moot except for issue (vi).

Respondent asserts that the amount remaining after deducting the Marital Share must be further reduced by post-agreement administrative expenses and implicit income computed from June 2, 1987 through October 10, 1990, and the Charitable Share of Estate taxes and interest; pursuant to the Second and Final Settlement Agreement.

(ii) Whether petitioner's charitable deduction is limited to the lesser of: (1) the amount passing to the charity under the 1982 Will and three codicils or (2) the amount actually passing to the charity.

Petitioner asserts that this is the same issue as raised by Respondent as the first issue under the Marital Issues, and Petitioner's contentions are generally the same.

Respondent asserts that there is a limitation.

(iii) Whether the amount of residuary corpus passing to the Charitable Share (pursuant to the 1982 Will and Codicils, as modified by the Second and Final Settlement Agreement) must be reduced by obligations charged to the Charitable Share, without regard to (a) whether the Estate charged those expenses to income on the Forms 1041 and (b) whether there are offsetting income adjustments under the Settlement.

Petitioner asserts that this is the same issue as raised by Respondent as the second issue under the Marital Issues and Petitioner's contentions are generally the same.

Respondent asserts that a reduction is necessary whether or not obligations are paid out of corpus.

(iv) What portion of the charitable share provided for under the Second and Final Settlement Agreement represents the portion of income earned by that share during estate administration.

Petitioner asserts that such determination of income is not necessary or proper because under the Second and Final Settlement Agreement, Petitioner is entitled to a charitable deduction for all of the date of death residuary corpus that does not pass to the Marital Share. In all events actual income must prevail over hypothetical income.

Respondent asserts that income earned by the charitable share during estate administration is a post death accretion to the value of the charitable gift, and is not deductible on the estate tax return. Respondent used seven percent (7%) in his calculation.

(v) What was the fair market value of the charitable residue on the date of agreement.

Petitioner asserts that this issue is legally irrelevant because under the Second and Final Settlement Agreement, Petitioner is entitled to a charitable deduction for all of the date of death residuary corpus that does not pass to the Marital Share. In all events, the C&S value is the proper value.

Respondent disagrees.

(vi) Whether the bequests pursuant to Item VII of the 1982 Will qualify for the charitable deduction.

Petitioner asserts that the provision is charitable in nature and Respondent asserts that part of the provision inures to the personal benefit of the missionaries named.

c. *Taxes and Interest.*

(i) Whether the charitable and marital deductions are reduced by additional Federal estate taxes and interest on Federal estate taxes.

Petitioner asserts that there are no additional Federal estate taxes due and that in any event, this Court has dealt with the effect of interest on estate tax deficiencies in *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987); and *Estate of Street v. Commissioner*, T.C. Memo. 1988-553.

Respondent asserts that the marital and charitable deductions must be reduced by additional estate taxes and interest.

Petitioner reserves the right to argue that Respondent bears the burden of proof with respect to the above issues. Respondent does not object to Petitioner claiming marital and charitable deductions in the amounts provided by the Second and Final Settlement Agreement (modifying the 1982 Will and three Codicils) subject to the limitations noted above.

2. Respondent does not dispute that Petitioner is entitled to a marital deduction. Petitioner agrees that Mrs.

Hubert must be entitled for life to all income from her designated interest. The parties agree that some portion of the funds and property passing to or for the benefit of Mrs. Hubert represents yearly income beginning one year atfer the date of death of the decedent. Petitioner agrees that a portion of the funds and property passing to or for the benefit of Mrs. Hubert represents yearly income beginning no later than one year after the date of death of decedent. Further, Petitioner contends that this income consists of the income distributed to Mrs. Hubert and the Marital Share in the aggregate amount of $1,918,979 ($1,219,603 plus $699,376) and addressed in Paragraph 10 a.(1), a.(2), and d. of the Second and Final Settlement Agreement. The parties further agree that the property passing from the Estate to Mrs. Hubert, the GPA Trust, and the QTIP Trust is not non-deductible terminable interest property as defined in Code Section 2056(b). As to the four properties in the QTIP Trusts, the parties agree that the QTIP election made by the Estate on the Federal Estate Tax Return (Form 706) was made properly.

3. The parties also agree that the interest passing to the charitable trust ("to feed starving people in the world, for treating the sick who are poor and starving, and to give Bibles to those who need to know Jesus Christ") addressed in Paragraph 8 of the Second and Final Settlement Agreement was exclusively for charitable purposes.

4. Petitioner does not dispute adjustment (a) in the Notice to the effect that the adjusted taxable gifts reported on the Federal Estate Tax Return does not include taxable gifts in the amount of $9,202 reported for the period ending December 31, 1980.

5. With respect to adjustment (b) in the Notice, the parties agree that the debts of the decedent are overstated in the Federal Estate Tax Return as a result of a duplication in the amount of $344,959. The parties agree that

the debts of decedent should be reduced accordingly and that the residuary estate and charitable contribution deduction shall be adjusted as necessary to reflect the overstatement of debts.

6. Respondent does not dispute that there have been delays in distributing the marital and charitable shares, which delays have been attributable to the inability of the fiduciaries to distribute the Estate pending resolution of the will contest and the tax controversy.

7. Further, Respondent does not dispute, for purposes of this proceeding, that the Second and Final Settlement Agreement is:

a. a good faith compromise,

b. of an arm's length *bona fide* will contest.

8. The parties agree that modification of the 1982 Will by the Second and Final Settlement Agreement is binding and dispositive of the federal estate tax treatment.

9. Petitioner intends to claim all available administrative expenses on the Federal Estate Tax Return, rather than the Federal Fiduciary Income Tax Returns, to the extent the claiming of such expenses would reduce the estate tax liability. Respondent reserves the right to examine the expenses Petitioner determines to claim on the Federal Estate Tax Return rather than the Fiduciary Income Tax Returns.

ABRAHAM N.M. SHASHY, JR.
Chief Counsel
Internal Revenue Service

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DATED: December 19, 1991

[Sent to Tax Court 12-6-93]

UNITED STATES TAX COURT

Docket No. 22333-90
JUDGE CLAPP

ESTATE OF OTIS C. HUBERT, DECEASED, CITIZENS & SOUTHERN TRUST COMPANY (GEORGIA) N.A., a national banking association, Temporary Administrator and Nominated Co-Executor, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

RESPONDENT'S COMPUTATION FOR ENTRY OF DECISION

The attached computation is submitted, on behalf of the respondent, in compliance with the Court's two opinions determining the issues in this case, together with a proposed decision and stipulation which are being lodged concurrently with said computation.

This computation is submitted without prejudice to respondent's right to contest the correctness of the decision entered herein by the Court.

DAVID L. JORDAN
Acting Chief Counsel
Internal Revenue Service

By: /s/ Willard N. Timm, Jr.
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Of Counsel:

WILLIAM A. Goss
Regional Counsel
DEAN R. MORLEY
District Counsel

Without prejudice to the right of appeal, it is agreed that the attached computation is in accordance with the opinion of the Tax Court in the above-entitled case.

/s/ David D. Aughtry
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Tax Court No. AD0165
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November 24, 1993
Date

COMPUTATION STATEMENT

In re: Estate of Otis C. Hubert
Deceased, Citizens & Southern
Trust Company (Georgia) N.A.
a national banking association,
Temporary Administrator and
Nominated Co-Executor
Docket No. 22333-90

Date of Death: June 2, 1986

Estate Tax

Tax Assessed and Paid		**$344,428.00**
Payment: September 9, 1987	**$344,428.00**	
Tax Liability:		**—0—**
Overpayment:		**$344,428.00**

I.R.C. §§ 6512(b) (3) (B) and 6511(b) (2)
Return filed September 9, 1987.
No claim filed.
Deficiency notice mailed August 31, 1990.

The details supporting the above computation are set forth on the attached pages.

In re: Estate of Otis C. Hubert, Deceased
C&S/Sovran Trust Company (Georgia),
N. A., A National Banking Association,
Co-Executor
Post Office Box 448
Atlanta, Georgia 30355

Docket No. 22333-90

Date of Death: June 2, 1986

Estate Tax

Tax assessed and paid		$344,428.00
Payment: September 9, 1987	$344,428.00	
Tax liability		None
Overpayment		$344,428.00

I.R.C. sections 6512(b) (3) (B) and 6511(b) (2)
Return filed September 9, 1987
No claim filed
Deficiency notice mailed August 31, 1990

The details supporting the above computation are set forth on the attached pages.

Dept of the Treasury—Internal Revenue Service

NAME: Estate of Otis C. Hubert

SSW: 252-05-1011

DATE OF DEATH: 02-Jun-86

Gross Estate-Per Return	30,263,421.00	
Adjustments-Per Attachment #1	0.00	
Gross Estate-As Corrected		30,263,421.00
Fixed Deductions-Per Return	2,773,203.00	
Adjustments-Per Attachment #1	26,796,269.00	
Fixed Deductions-As Corrected		29,569,472.00
Interest Ded - Per Attachment #1		0.00
Marital Ded - Per Attachment #2		200,747.00
Charitable Ded - Per Attachment #2		200,000.00
Taxable Estate-As Corrected		273,202.00
Adjusted Taxable Gifts		154,561.00
Taxable Estate Plus Adjusted Taxable Gifts		427,763.00
Gross Estate Tax		131,239.00
Less: Aggregate Gift Tax		7,481.00
Unified Credit		155,800.00
Net		(32,042.00)
Less: Gift Tax Cr		0.00
Less: Foreign Tax Cr		0.00
Less: CR for Tax on Prior Trans		0.00
Total Tax Liability		0.00
Tax-Per Return or as Previously Adjusted		344,428.00
Gross Deficiency (Overassessment)		(344,428.00)
Less: Add'l St Death Tax Cr - If Substantiated		0.00
Net Deficiency (Overassessment)		(344,428.00)

Estate of Otis C. Hubert
Date of Death: June 2, 1986

Statement
Schedule 2

Explanation of Adjustments

(a) In 101 T.C. No. 22 the Court held that the amount passing to the marital share is $13,353,572.00 in accordance with the stipulation of facts filed with the Tax Court. Accordingly, the taxable estate is decreased $13,353,572.00.

(b) In T. C. Memo. 1993-482 the Court held that the bequests to the subtrusts for missionary work of charitable organizations in the amount of $200,000.00 qualify for the charitable deduction. Accordingly, the taxable estate is decreased $200,000.00.

(c) In 101 T. C. No. 22 the Court held that the amount passing to the charitable share is $12,870,864.00 in accordance with the stipulation of facts filed with the Tax Court. Accordingly, the taxable estate is decreased $12,870,864.00.

(d) In accordance with the stipulation of facts filed by the parties, it is determined that claims against the estate in the amount of $371,833.00 are allowable as a deduction. Accordingly, the taxable estate is decreased $371,833.00.

Dept of the Treasury - Internal Revenue Service

ATTACHMENT #1

Estate of Otis C. Hubert
Adjustments to Gross Estate

# 1	_____	0.00
# 2	_____	0.00
# 3	_____	0.00
# 4	_____	0.00
# 5	_____	0.00
# 6	_____	0.00
# 7	_____	0.00
# 8	_____	0.00
# 9	_____	0.00
#10	_____	0.00
#11	_____	0.00
#12	_____	0.00
Total Adjustments		0.00

Adjustments to Fixed Deductions

# 1	Schedule M	13,353,572.00
# 2	Schedule O	12,870,864.00
# 3	Schedule O	200,000.00
# 4	Schedule J - Claims	371,833.00
# 5	_____	0.00
# 6	_____	0.00
# 7	_____	0.00
# 8	_____	0.00
# 9	_____	0.00
#10	_____	0.00
#11	_____	0.00
#12	_____	0.00
Total Adjustments		26,796,269.00

Dept of the Treasury - Internal Revenue Service

ATTACHMENT #2

Computation of Residue

Corrected Gross Estate		30,263,421.00
Less: Corrected Fixed Deductions		29,569,472.00
Interest Deduction		0.00
Fixed Marital Deduction		220,747.00
Fixed Charitable Deduction		200,000.00
Federal Estate Tax Times	0.00000000%	0.00
State Death Tax Pd Times	0.00000000%	0.00
Other Residue Reductions		4,808,000.00
Corrected Residue Amount		0.00

Form 3623 | STATEMENT OF ACCOUNT | Schedule Number 1

Name of Taxpayer
Estate of Otis C. Hubert

Kind of Tax Income | Docket Number 223333-90 | In Reply Refer To CC:ATL-TL:JMK:GPM

Date of Death:	06-02-86							
Tax/ Addition to Tax	Tax							
	Date	Amount	Date	Amount	Date	Amount	Date	Amount
Revised Liability	XXXXXXXX	None	XXXXXXXX		XXXXXXXX		XXXXXXXX	
Assessment (tax on return)	XXXXXXXX	$596,551.47	XXXXXXXX		XXXXXXXX		XXXXXXXX	
Additional Assessments								
Overassessments	03-14-88	$252,123.47						
TOTAL ASSESSMENTS	XXXXXXXX	$344,428.00	XXXXXXXX	$0.00	XXXXXXXX	$0.00	XXXXXXXX	$0.00
Change in Assessment	XXXXXXXX	($344,428.00)	XXXXXXXX	$0.00	XXXXXXXX	$0.00	XXXXXXXX	$0.00
Revised Liability	XXXXXXXX	None	XXXXXXXX		XXXXXXXX	$0.00	XXXXXXXX	$0.00
Payments: Statutory Date								
Payment with return	09-09-87	$344,428.00						
Less Refunds or Credit								
TOTAL PAYMENTS	XXXXXXXX	$344,428.00	XXXXXXXX	$0.00	XXXXXXXX	$0.00	XXXXXXXX	$0.00
Balance Due (or overpayment)	XXXXXXXX	($344,428.00)	XXXXXXXX	$0.00	XXXXXXXX	$0.00	XXXXXXXX	$0.00

Date of Death	Internal Revenue Code Reference: Section	Year	Date Return Filed	Date Agreement Signed	Statute Extended To	Date Deficiency Notice Mailed	Date Claim Filed	Amount Of Claim
06-02-86	6512(b)(3)(B)	1986	09-09-87			08-31-90		
06-02-86	6511(b)(2)	1986	09-09-87			08-31-90		

UNITED STATES TAX COURT

Docket No. 22333-90
JUDGE CLAPP

ESTATE OF OTIS C. HUBERT, DECEASED, C&S SOVERAN TRUST COMPANY (GEORGIA) N.A., a national banking association, Co-Executor, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DECISION

Pursuant to the opinions of the Court filed on October 19, 1993, and incorporating the facts recited in the respondent's computation, as well as the Stipulation, it is

ORDERED and DECIDED: That there is an overpayment in estate tax in the amount of $344,428.00, which amount was paid on September 9, 1987, and for which amount a claim could have been filed, under the provisions of I.R.C. §§ 6512(b)(3)(B) and 6511(b)(2), on August 31, 1990, the date of the mailing of the notice of deficiency.

(signed) Charles E. Clapp II
Judge

Entered: Dec. 14, 1993

* * * * *

Docket No. 22333-90

It is hereby stipulated that the Court may enter the foregoing decision in the above-entitled case in accordance with the opinions ofthe Court, the respondent's computation, and the stipulation submitted herewith.

DAVID L. JORDAN
Acting Chief Counsel
Internal Revenue Service

By: /s/ Dean R. Morley
DEAN R. MORLEY
District Counsel
Tax Court No. MD0394
P. O. Box 901
Atlanta, Georgia 30370
Tel. No. (404) 331-6120

Date: Dec. 3, 1993

/s/ David D. Aughtry
DAVID D. AUGHTRY
CHAMBERLAIN, HRDLICKA, WHITE
WILLIAM & MARTIN
Tax Court No. AD0165
1400 Harris Tower
233 Peachtree Street, NE
Atlanta, Georgia 30303
Tel. No. (404) 659-1410

Date: November 29, 1993

SUPREME COURT OF THE UNITED STATES

No. 95-1402

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED, ET AL.

ORDER ALLOWING CERTIORARI

Filed April 29, 1996

The petition herein for a writ of certiorari to the United States Court of Appeals for the Eleventh Circuit is granted.

April 29, 1996

☆ U. S. GOVERNMENT PRINTING OFFICE: 1996 405017 40132

(5)

Supreme Court, U.S.
FILED
JUN 13 1996
CLERK

No. 95-1402

In the Supreme Court of the United States

OCTOBER TERM, 1995

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED,
C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

DREW S. DAYS, III
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LORETTA C. ARGRETT
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QUESTION PRESENTED

Whether, in calculating the taxable estate for the purpose of the federal estate tax, the marital and charitable deductions allowed by Sections 2055 and 2056 of the Internal Revenue Code, 26 U.S.C. 2055, 2056, are reduced by the expenses of administration of the estate.

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In the Supreme Court of the United States

OCTOBER TERM, 1995

No. 95-1402

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED,
C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-23a) is reported at 63 F.3d 1083. The opinion of the Tax Court (Pet. App. 26a-79a) is reported at 101 T.C. 314.

JURISDICTION

The judgment of the court of appeals was entered on September 12, 1995. A petition for rehearing with suggestion for rehearing en banc was filed on October 27, 1995, and was denied on December 5, 1995 (Pet. App. 24a-25a). The petition for a writ of certiorari was filed on March 1, 1996, and was granted on

April 29, 1996. The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

STATUTES AND REGULATION INVOLVED

1. 26 U.S.C. 212 provides:

> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

2. 26 U.S.C. 641(b) provides:

> The taxable income of an estate or trust shall be computed in the same manner as in the case of an individual, except as otherwise provided in this part. The tax shall be computed on such taxable income and shall be paid by the fiduciary.

3. 26 U.S.C. 642(g) provides:

> Amounts allowable under section 2053 or 2054 as a deduction in computing the taxable estate of a decedent shall not be allowed as a deduction (or as an offset against the sales price of property in determining gain or loss) in computing the taxable income of the estate or of any other person, unless there is filed, within the time and in the manner and form prescribed by the Secretary, a statement that the amounts have not been allowed

> as deductions under section 2053 or 2054 and a waiver of the right to have such amounts allowed at any time as deductions under section 2053 or 2054. This subsection shall not apply with respect to deductions allowed under part II (relating to income in respect to decedents).

4. 26 U.S.C. 2053(a) provides:

> For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate such amounts—
>
> (1) for funeral expenses,
> (2) for administration expenses,
> (3) for claims against the estate, and
> (4) for unpaid mortgages on, or any indebtedness in respect of, property where the value of the decedent's interest therein, undiminished by such mortgage or indebtedness, is included in the value of the gross estate,
>
> as are allowable by the laws of the jurisdiction, whether within or without the United States, under which the estate is being administered.

5. 26 U.S.C. 2055 provides, in relevant part:

> (a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall be determined by deducting from the value of the gross estate the amount of all bequests, legacies, devises, or transfers—
>
> * * * * *

(2) to or for the use of any corporation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes * * *.

* * * * *

(c) If the tax imposed by section 2001, or any estate, succession, legacy, or inheritance taxes, are, either by the terms of the will, by the law of the jurisdiction under which the estate is administered, or by the law of the jurisdiction imposing the particular tax, payable in whole or in part out of the bequests, legacies, or devises otherwise deductible under this section, then the amount deductible under this section shall be the amount of such bequests, legacies, or devises reduced by the amount of such taxes.

(d) The amount of the deduction under this section for any transfer shall not exceed the value of the transferred property required to be included in the gross estate.

* * * * *

6. 26 U.S.C. 2056 provides, in relevant part:

(a) For purposes of the tax imposed by section 2001, the value of the taxable estate shall, except as limited by subsections (b) and (c), be determined by deducting from the value of the gross estate an amount equal to the value of any interest in property which passes or has passed from the decedent to his surviving spouse, but only to the extent that such interest is included in determining the value of the gross estate.

* * * * *

(b)(4) In determining for purposes of subsection (a) the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section—

(A) there shall be taken into account the effect which the tax imposed by section 2001, or any estate, succession, legacy, or inheritance tax, has on the net value to the surviving spouse of such interest; and

(B) where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.

7. 26 C.F.R. 20.2056(b)-4(a) provides, in relevant part:

The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of the date of the decedent's death * * *. The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limita-

tions upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

STATEMENT

This case concerns the estate tax liability of the estate of Otis C. Hubert, who was a resident of Georgia at his death. Mr. Hubert died in 1986, leaving an estate greater than $30,000,000 (Pet. App. 3a).

1. An estate is a taxable entity that is subject to both the federal estate tax and the federal income tax. The estate tax is imposed on the taxable estate, which is the gross value of the decedent's estate at the time of death less deductions authorized by statute. 26 U.S.C. 2001, 2051. The income tax is imposed annually on the net income received by the estate from the administration of the assets of the estate during the period prior to distribution of those assets to the heirs and other claimants. 26 U.S.C. 641(b).

This case involves the "marital" and "charitable" deductions which, along with other deductions, are subtracted from the gross value of the decedent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. Under Section 2056(a) of the Code, the "marital deduction" is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)). Similarly, the "charitable deduction" is limited to the amount of "the value of the * * * property" that is transferred

to a charitable organization (26 U.S.C. 2055(d)). The date-of-death "value" of the property in Mr. Hubert's estate that "passes" to his surviving spouse or to a charity thus passes free of the estate tax under Sections 2055 and 2056.

2. Mr. Hubert's last will was executed in 1982 and was thereafter amended by two codicils. Following his death, the provisions of the will and codicils were challenged by various interested parties. The resulting litigation was settled under an agreement that was approved by the Georgia probate court in 1990 (Pet. App. 29a). The parties to that litigation stipulated that the distribution of the estate was to be controlled by this settlement agreement, rather than by the decedent's will (*id.* at 29a-30a).

Under the terms of the settlement agreement, the residuary assets of the estate were allocated between a marital and a charitable share (Pet. App. 30a). The marital share was in turn divided between two trusts: One trust provides for the payment of income for life to the decedent's wife, with a general power of appointment to her in the remainder; the other provides for the payment of income for life to the decedent's wife, with the remainder to charity.[1] The charitable

[1] The first of these two trusts is a "GPA" trust; the second is a "QTIP" trust. A trust that qualifies for the marital deduction under Section 2056(b)(5) of the Code by giving the surviving spouse both a lifetime income interest and a general power of appointment over the corpus of the trust is referred to as a "GPA" (general power of appointment) marital trust. If the spouse has only a lifetime income interest in the trust, but the trust otherwise is a "qualified terminable interest property" (QTIP) trust by virtue of an irrevocable election, it also qualifies for the marital deduction. See 26 U.S.C. 2056(b)(7)(A)(i) and 2044. The marital deduction extends to

share of the residuary assets was distributed to a trust for the charitable beneficiaries. Under the terms of the settlement agreement, the marital and charitable shares were $13,353,572 and $12,870,864, respectively (*id.* at 74a). The administration expenses of the estate were to be allocated between the marital and charitable shares (*id.* at 30a).

3. The litigation challenging the will delayed the final administration of the estate. During the years prior to distribution of the estate's assets, the estate earned significant amounts of income—between 1986 and 1991, the estate's income exceeded $4,500,000. During this same period, the estate also incurred significant administration expenses, including attorney's fees, that exceeded a total of $2,000,000 (Pet. App. 3a).

Under Georgia probate law, an executor may charge payments of administration expenses either against the income of the estate or against its principal, if the will so provides. Ga. Code Ann. § 53-12-219(e) (Michie 1995); see Ga. Code Ann. § 53-15-3 (Michie 1982). In this case, the decedent's will authorized the executors "to charge any expenses against income or principal or apportion the same" (Pet. App. 37a). Acting pursuant to this authority, the executors charged $506,989 of the administration expenses against the principal of the estate in the state probate proceedings. As permitted by 26 U.S.C. 2053(a)(2), those charges were deducted from the gross estate in calculating the value of the taxable estate for purposes of the federal estate tax (Pet. App. 3a). All other administration expenses

---

both types of trust, and the corpus of both trusts is includable in the estate of the surviving spouse.

were charged by the executors against the post-death income earned by the estate (*id.* at 37a). As permitted by 26 U.S.C. 212, these charges were deducted from the income earned by the estate during the period of administration for purposes of the federal income tax, as expenses paid for the production of income (Pet. App. 37a-39a).

Section 642(g) of the Internal Revenue Code authorizes executors to elect to deduct administration expenses either on the estate tax return or on the estate's income tax returns. 26 U.S.C. 642(g). When administrative expenses are paid from the corpus of the residuary estate left to the surviving spouse and are deducted on the estate tax return (under 26 U.S.C. 2053(a)(2)), this reduces directly the amount of property that passes to the surviving spouse, and therefore reduces directly the marital deduction under 26 U.S.C. 2056(a). *Estate of Luehrmann* v. *Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961); *Estate of Roney* v. *Commissioner*, 33 T.C. 801, 804 (1960), aff'd per curiam, 294 F.2d 774 (5th Cir. 1961). The executors in this case accordingly reduced the amount of the marital and charitable deductions claimed on the estate tax return by the amount of the administration expenses charged against the principal of the estate. They did not, however, make such reductions in the marital and charitable deductions for the administration expenses charged against the income of the estate and deducted in the calculation of the estate's income tax pursuant to Sections 212 and 642(g) (Pet. App. 37a).

4. The Commissioner of Internal Revenue issued a notice of deficiency with respect to the estate taxes owed by the estate. The Commissioner took the position that the marital and charitable deductions of

the estate had been overstated and must be reduced by the total administration expenses paid by the estate, whether the executors elect to charge those expenses against the principal or the income of the estate (Pet. App. 30a, 37a). The estate contended that these deductions must be reduced by administration expenses only when the expenses are paid from the corpus of the estate and not when they are paid from the post-death income earned by that corpus.

5. a. In a reviewed opinion with two dissents, the Tax Court sustained the estate's position (Pet. App. 26a-79a). The court concluded that administration expenses that are charged, under state law, against estate income (rather than corpus) do not reduce the value of the property passing to the spouse and to the charity, and therefore do not reduce the marital and charitable deductions. In so holding, the court relied (*id.* at 43a) on its prior decision in *Estate of Street* v. *Commissioner*, T.C. Memo. 1988-553, which the Sixth Circuit had reversed in part (974 F.2d 723 (1992)). The Tax Court reasoned that "administration expenses come into existence only after the death of the decedent and may relate to both income and corpus" (Pet. App. 42a). The court stated that, because "administration expenses logically can be charged to either income or corpus" (*ibid.*), the allocation of those expenses under state law determines whether they are deductions from the corpus of the estate or only from the income earned by that corpus. The court concluded that, since Georgia law permits administration expenses to be allocated to income, and since the expenses involved in this case were allocated to income by the executors, these expenses do not reduce the corpus of the marital and charitable interests and therefore have no effect on the proper

value of the marital and charitable deductions (*id.* at 39a).

The Tax Court stated that the regulations adopted under Section 2056 did not alter its conclusion. Those regulations specify that (26 C.F.R. 20.2056(b)-4(a)):

> The value, for the purpose of the marital deduction, of any deductible interest which passed from the decedent to the surviving spouse is to be determined as of the date of the decedent's death[.] * * * In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. An example of a case in which this rule may be applied is a bequest of a property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

The Tax Court stated that this regulation does not "mandat[e] a setoff against the marital deduction for administration expenses" but "is merely a valuation provision which requires material limitations on the right to receive income to be taken into account when valuing the property interest passing to the surviving spouse" (Pet. App. 40a). The court held that the fact that the interest of the surviving spouse is burdened by the obligation to pay administration expenses is not "a material limitation on the right to receive income that would have a significant effect on the date-of-death value of the property of the estate" (*ibid*).

The Tax Court recognized that in *Estate of Street* v. *Commissioner*, 974 F.2d at 728, the Sixth Circuit

held that administration expenses reduce the value of the property passing to the spouse, and therefore reduce the amount of the marital deduction, even when these expenses are charged to the income from the estate. The court further noted that the Federal Circuit had applied and followed *Estate of Street* in a parallel case involving the charitable deduction (Pet. App. 46a, citing *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993)). The Tax Court stated that it disagreed with the reasoning of the Sixth Circuit and "decline[d] to follow its decision in *Estate of Street*" (Pet. App. 46a).

b. Judges Halpern and Beghe each wrote dissenting opinions. Judge Halpern stated that the relevant inquiry is whether the income of the estate would have been received by the surviving spouse or charitable beneficiary if that income had not been used to pay administration expenses (Pet. App. 66a). If, as in this case, it would have been, "then it follows easily that, when such income is used for administration expenses, rather than [being] received by the surviving spouse or charitable beneficiary, the value of the interest passing from the decedent to the surviving spouse or charitable beneficiary is decreased," and the marital and charitable deductions must therefore be reduced (*ibid.*). Judge Halpern stated (*id.* at 67a) that the Fifth Circuit was correct in concluding in *Alston* v. *United States*, 349 F.2d 87, 89 (1965), that:

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity

> is not diminished by such payments * * * " as argued by the executors.

Judge Halpern further observed that the Tax Court majority fails to explain "how we might be justified in declining to take into account material limitations on a surviving spouse's right to income" and is thus inconsistent with the Treasury regulations under Section 2056 (Pet. App. 64a, citing 26 C.F.R. 20.2056 (b)-4(a)).

Judge Beghe agreed with the dissenting opinion of Judge Halpern (Pet. App. 70a). Judge Beghe noted that numerous appellate decisions, as well as academic and professional writings, have agreed with the Commissioner's interpretation of these statutory provisions (*id.* at 77a-78a). He stated that the Tax Court's inconsistent and erroneous position "stands virtually alone on this issue" (*id.* at 77a).

6. A divided panel of the Eleventh Circuit affirmed (Pet. App. 1a-23a). The majority did not explain its conclusions, electing instead to "simply attach" and adopt the relevant portion of the Tax Court opinion "as our own, as completely as if we had set it forth herein" (*id.* at 2a). The majority acknowledged that, having thus adopted the Tax Court opinion, its holding in this case "brings us in conflict with the two other circuits which have decided the issue" (*ibid.*, citing *Estate of Street* v. *Commissioner*, *supra*; *Burke* v. *United States*, *supra*). The majority added only that it agreed with the analysis of the Tax Court rather than the conflicting analysis of the Sixth and Federal Circuits in *Estate of Street* and *Burke* (Pet. App. 3a).

Judge Dubina dissented (Pet. App. 18a-23a). He explained that the majority's holding "disregards fun-

damental federal estate taxation principles in light of state law, which allows administration expenses to be paid out of post-mortem income" (*id.* at 18a). The "fundamental federal estate taxation principle[]" disregarded by the majority is that "administration expenses, although unascertained on the date of death, are deemed to accrue at the decedent's death * * * [and] 'are charges against the gross estate'" (*id.* at 18a, 19a, quoting *Burke* v. *United States*, 994 F.2d at 1581). Judge Dubina noted (Pet. App. 20a-23a) that the majority's holding is in conflict not only with the decision of the Sixth Circuit in *Estate of Street* and the decision of the Federal Circuit in *Burke*; it also conflicts with the decisions of the Fifth Circuit in *Alston* v. *United States*, 349 F.2d 87 (1965), and in *Ballantine* v. *Tomlinson*, 293 F.2d 311 (1961), which held that the marital and charitable deductions are reduced by the amount of administration expenses even when these expenses are paid from post-death income.[2]

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[2] Judge Dubina noted (Pet. App. 22a) that these older Fifth Circuit decisions are binding on the Eleventh Circuit (*Bonner* v. *City of Prichard*, 661 F.2d 1206, 1209 (11th Cir. 1981) (en banc)) and should have been followed as circuit precedent in this case. The majority disagreed, stating that the provisions of state law involved in the *Alston* and *Ballantine* cases differed from the Georgia probate provisions involved in this case (Pet. App. 4a n.1). As Judge Dubina pointed out (*id.* at 21a), however, *Alston* and *Ballantine* do not rely on state law but instead hold that "administration expenses must be deducted from the gross estate even though paid out of post-mortem income." 349 F.2d at 89. See 293 F.2d at 313.

SUMMARY OF ARGUMENT

This case concerns the correct application of the "marital" and "charitable" deductions under the federal estate tax. These deductions are subtracted from the gross value of the decedent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. The "marital" deduction is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)). The "charitable" deduction is limited to "the value of the * * * property" that is transferred to a charitable organization (26 U.S.C. 2055(d)). The "value" at the date of death of the property in the estate that passes to a surviving spouse or charity thus passes free of the estate tax.

When a marital or charitable bequest is burdened by the obligation of paying estate taxes or administration expenses of the estate, those payments—whether made directly from the corpus of such bequests or from the income earned by that corpus—must be subtracted from the gross value of the bequests in determining the "real value of the gift" (*United States* v. *Stapf*, 375 U.S. 118, 126 (1963)). Sections 2055(c) and 2056(b)(4)(A) expressly require that, when the burden of paying estate taxes is placed on the marital or charitable bequest, the amount of the marital or charitable deduction must be "reduced by the amount of such taxes" (26 U.S.C. 2055(c); see 26 U.S.C. 2056(b)(4)(A)). Under Section 2056(b)(4)(B), this same reduction must occur when the marital or charitable bequest is burdened with the obligation of paying administration expenses or other claims against the estate. 26 U.S.C. 2056(b)(4)(B). As this

Court held in *United States* v. *Stapf*, 375 U.S. at 126, to arrive at "the real value" of a bequest at the date of death under Section 2056(b)(4)(B), the costs resulting from encumbrances and obligations imposed on the transfer of that bequest must be subtracted from the gross value of the gift.

At the date of death, administration expenses are an encumbrance on the gross estate even though the amount of these expenses is not then ascertainable. When, as in the present case, the decedent's will requires that administration expenses be paid from the marital or charitable bequest, and when estate income to which the marital or charitable recipient would otherwise be entitled is used to pay those expenses, "the real value of the gift" has been reduced by these payments. The applicable Treasury regulation has therefore long provided that the "net value" of the marital bequest (and therefore the amount of the marital deduction allowed by Section 2056(a)) is reduced when "the income from the property * * * is to be used to pay expenses incurred in the administration of the estate" (26 C.F.R. 20.2056(b)-4(a)). For the reasons stated in *United States* v. *Stapf*, 375 U.S. at 127 n.11, that regulation is entitled to substantial deference.

Economic logic and common sense dictate the same conclusion. The "value" of property left as a bequest includes, as one of the sticks in the bundle of rights, the stream of income from that property. If, however, the income from that property is severed and used to pay expenses of the estate, the "real value" of that property to the legatee is correspondingly diminished. This is equally true whether such expenses (i) are paid from the income earned by the corpus of the bequest or (ii) are paid directly out of the corpus with

the income retained for the benefit of the marital or charitable interest. In either situation, when the marital or charitable bequest is burdened by the obligation of paying administration expenses, the "real value" of the bequest is reduced by the amount of those expenses, and the marital or charitable deduction is therefore reduced commensurately under Sections 2055(d) and 2056(a).

ARGUMENT

ADMINISTRATION EXPENSES PAID FROM THE CORPUS OF A CHARITABLE OR MARITAL BEQUEST, OR FROM THE INCOME EARNED BY THE CORPUS ATTRIBUTABLE TO SUCH BEQUESTS, MUST BE SUBTRACTED FROM THE GROSS VALUE OF THOSE BEQUESTS IN DETERMINING THE MARITAL AND CHARITABLE DEDUCTIONS PERMITTED UNDER THE FEDERAL ESTATE TAX

An estate is a taxable entity. It is subject to both the federal estate tax and the federal income tax. The estate tax is imposed on the taxable estate, which is the gross value of the decedent's estate at the time of death less deductions authorized by statute. 26 U.S.C. 2001, 2051. The income tax is imposed annually on the net income received by the estate from the administration of the assets of the estate during the period prior to distribution of those assets to the heirs and other claimants. 26 U.S.C. 641(b).

This case concerns the correct application of the "marital" and "charitable" deductions under the federal estate tax. These deductions (along with others) are subtracted from the gross value of the decedent's estate at the time of death in determining the taxable estate. See 26 U.S.C. 2053-2056. Under Section

2056(a) of the Code, the "marital deduction" is the "amount equal to the value of any interest in property which passes * * * from the decedent to his surviving spouse" (26 U.S.C. 2056(a)).[3] Similarly, the "charitable deduction" is limited to the amount of "the value of the * * * property" that is transferred to a charitable organization (26 U.S.C. 2055(d)). Thus, the "value" of the property in Mr. Hubert's estate "which passes" to his surviving spouse or to a charity passes free of the estate tax under Sections 2055 and 2056.

The marital and charitable deductions both require a determination of the date-of-death "value" of the transferred property.[4] This case concerns the cor-

[3] The marital deduction was added to the Code in 1948. Revenue Act of 1948, ch. 168, § 361, 62 Stat. 117. It was enacted to extend to taxpayers in common law states the "estate splitting" advantage that had previously been enjoyed only by residents of community property states. H.R. Rep. No. 1274, 80th Cong., 2d Sess. 24-26 (1948) (1948-1 C.B. 241, 260-261); S. Rep. No. 1013, 80th Cong., 2d Sess. 26-29 (1948) (1948-1 C.B. 285, 303-306). See *United States* v. *Stapf*, 375 U.S. 118, 128 (1963). Although the marital deduction was originally limited to 50 percent of the value of the adjusted gross estate, Congress removed that limitation in 1981. See 26 U.S.C. 2056(a).

[4] Courts have therefore uniformly read these provisions in *pari materia*, construing the scope of the two deductions in a consistent fashion. See, *e.g.*, *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993) (charitable deduction); *Alston* v. *United States*, 349 F.2d 87 (5th Cir. 1965) (charitable deduction); *Estate of Street* v. *Commissioner*, 974 F.2d 723 (6th Cir. 1992) (marital deduction); *Ballantine* v. *Tomlinson*, 293 F.2d 311 (5th Cir. 1961) (marital deduction). This Court has noted that "strong reasons urge identical construction" of "the same phrases * * * concerning the same subject matter." *Merrill* v. *Fahs*, 324 U.S. 308, 313 (1945). See

rect determination of the "value" of such bequests when they are burdened by the obligation of paying administration expenses of the estate. It is not disputed that, to the extent that payments of administration expenses or other charges against the estate are made directly from the corpus of marital or charitable bequests, the "value" of those bequests is diminished and the marital and charitable deductions are therefore reduced commensurately under Sections 2055 and 2056. See Pet. App. 37a; *Estate of Luehrmann* v. *Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961) ("Obviously, if the administration expenses are in fact paid out of the corpus of the estate, the residue of the estate will be diminished by such payment."); *Estate of Roney* v. *Commissioner*, 33 T.C. 801, 804 (1960), aff'd per curiam, 294 F.2d 774 (5th Cir. 1961).

In this case, however, the executors elected under applicable state law to charge a portion of the administration expenses against the income earned by the corpus of the marital and charitable bequests rather than directly against the corpus of those bequests. The question presented is whether the obligation imposed upon the marital and charitable bequests to pay administration expenses reduces the "value" of those bequests—and therefore the amount of the permitted deductions under Section 2055 and 2056—when the actual payment of the expenses is

also *Crawford Fitting Co.* v. *J.T. Gibbons, Inc.*, 482 U.S. 437, 445 (1987). The legislative history of the estate tax reflects that Congress intended that the same principles would apply in determining the "value" of marital and charitable bequests for purposes of these deductions. See page 21 & note 5, *infra*.

made from the income, rather than the corpus, attributable to those bequests.

1. This is the fourth case in which this Court has been called upon to determine whether the marital and charitable deductions under the federal estate tax are reduced by a burden placed on the bequest that reduces its "value." In the first of these cases, the Court addressed whether estate taxes that were required to be paid from a charitable bequest reduced the value of the charitable bequest and therefore reduced the charitable deduction under the estate tax. In *Edwards* v. *Slocum*, 264 U.S. 61 (1924), the Court held that the burden of paying such taxes should not be considered in valuing the charitable bequest or the taxable estate because the tax is imposed on "the interest which ceased by reason of the death" rather than on the "interest to which some person succeeds on a death." *Id.* at 63, quoting *Knowlton* v. *Moore*, 178 U.S. 41, 49 (1900).

Congress disapproved of the reasoning and the conclusion of *Edwards* v. *Slocum* and enacted, as a curative provision, what is now Section 2055(c) of the Code. That Section specifies that, when the burden of paying estate taxes is placed on a charitable bequest, the gross value of that bequest as of the date of death must be "reduced by the amount of such taxes" in determining the charitable deduction. 26 U.S.C. 2055(c). In *Harrison* v. *Northern Trust Co.*, 317 U.S. 476, 481 (1943), when the same issue arose again, the Court acknowledged that Section 2055(c) had been enacted to overrule the decision in *Edwards* v. *Slocum*. The Court explained that the new statute sought to ensure that, when the obligation to pay taxes is placed on a charitable bequest, the charitable deduction must be reduced because that obligation

"actually reduce[s] the amount of such bequest" (317 U.S. at 480, quoting H.R. Rep. No. 708, 72d Cong., 1st Sess. 49 (1932)).

When Congress enacted the marital deduction in 1948, the same limitation that had previously been enacted for the charitable deduction in Section 2055(c) was incorporated into what is now Section 2056(b)(4)(A) of the Code. See note 3, *supra*. That Section specifies that, "[i]n determining * * * the value of any interest in property passing to the surviving spouse for which a deduction is allowed by this section[,] * * * there shall be taken into account the effect which the [federal estate] tax * * *[,] or any * * * inheritance tax, has on the net value to the surviving spouse of such interest * * *." 26 U.S.C. 2056(b)(4)(A).[5]

As part of that same legislation, Congress also sought to express the underlying principle in a broader context—enacting an additional, more general provision based upon principles that are "generally applicable in determining the net value of any gift or bequest." S. Rep. No. 1013, 80th Cong., 2d Sess., Pt. 2, at 6 (1948). That provision, which is now Section 2056(b)(4)(B) of the Code, specifies that (26 U.S.C. 2056(b)(4)(B) (emphasis added)):

> *In determining for purposes of [Section 2056(a)] the value of any interest in property passing to the surviving spouse* for which a deduction is allowed by this section * * * *where such interest or property is encumbered in any manner*, or

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[5] Congress noted that the provisions of Section 2056(b)(4)(A) are "substantially the same" as the charitable deduction provisions (Section 2055(c)) upon which they are modeled. S. Rep. No. 1013, *supra*, Pt. 2, at 6.

> where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, *such encumbrance or obligation shall be taken into account* in the same manner as if the amount of a gift to such spouse of such interest were being determined.

The history of Section 2056(b)(4)(B) explains its broad purpose. The statute seeks to ensure that, when expenses must be paid from property bequeathed to the surviving spouse, the burden of paying those expenses will be treated as a reduction in the value of that bequest and, therefore, a reduction in the marital deduction permitted by Section 2056(a). See S. Rep. No. 1013, *supra*, Pt. 2, at 6. The legislative history expressly states that this same result is required whether the expenses are paid from the corpus, or from the income attributable to the corpus, of the marital bequest (*ibid.*):

> If the decedent by his will leaves the residue of his estate to the surviving spouse and she pays, or if the estate income is used to pay, claims against the estate so as to increase the residue, such increase in the residue is acquired by purchase and not by bequest. Accordingly, the value of any such additional part of the residue passing to the surviving spouse cannot be included in the amount of the marital deduction.

In *United States* v. *Stapf*, 375 U.S. 118 (1963), the Court interpreted and applied the text of Section 2056(b)(4)(B). The estate in *Stapf* contended that the statutory phrase "incumbrance or obligation" referred only to "a payment to be made *out of* property passing to the surviving spouse" (375 U.S. at 126). Under that interpretation, since the property that

the widow was required to surrender to obtain the bequest in *Stapf* did not come "out of" the property passing to her under the will but, instead, from property she already possessed, the estate contended that the payment did not reduce the amount of the marital deduction.

This Court rejected that contention. The Court explained that "the statute speaks of an obligation '*with respect* to the passing' " of the bequest (375 U.S. at 126). Since the widow's obligation was incurred "with respect to" the bequest made to her, the marital deduction had to be reduced by the costs incurred in disposing of that burden. *Ibid.* The Court explained that the statute is designed to ensure that the amount of the marital deduction is "the net economic interest received by the surviving spouse." *Ibid.* Any encumbrance or obligation imposed on the marital bequest must be subtracted from the gross value of that bequest to determine the "real value" of the bequest—and therefore to determine the permissible marital deduction under Section 2056(a). 375 U.S. at 126. See also *id.* at 129 ("the value of a conditional bequest to a widow should be the value of the property given to her less the value of the property she is required to give to another"). The Court explained that, in determining the proper scope of the deduction allowed under Section 2056(a) for the "value" of a bequest made to a spouse, "[t]he appropriate reference * * * is not to the value of the gift moving from the deceased spouse but to the net value of the gift received by the surviving spouse." 375 U.S. at 125.

In the present case, the marital and charitable bequests are burdened by the prior obligation of paying administration expenses. Just as in *Stapf*, the marital deduction must be reduced by the costs im-

posed by that obligation to determine the "real value" of the bequest and thus the permissible marital deduction under Section 2056(a).

2. Prior to the decision in the present case, the courts of appeals consistently and properly relied on the text and history of Section 2056(b)(4)(B) and on this Court's decision in *United States* v. *Stapf* in reaching this same conclusion. See, *e.g.*, *Burke* v. *United States*, 994 F.2d 1576, 1581-1582 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993); *Estate of Street* v. *Commissioner*, 974 F.2d 723, 726 (6th Cir. 1992); *Ballantine* v. *Tomlinson*, 293 F.2d 311, 313 (5th Cir. 1961); note 4, *supra*.

a. The federal estate tax is a tax imposed on the transfer of the decedent's estate. 26 U.S.C. 2001(a); see *Riggs* v. *Del Drago*, 317 U.S. 95, 97 (1942); *Ithaca Trust Co.* v. *United States*, 279 U.S. 151, 155 (1929); *Y.M.C.A.* v. *Davis*, 264 U.S. 47, 50 (1924). Because administration expenses are necessarily incurred in the transfer of a decedent's estate, and are to be paid from the assets of the estate, they are an encumbrance on the gross estate that exists at the date of death, even though the amount of these expenses is not then ascertainable.[6] When that encumbrance falls upon the portion of the estate that comprises the marital or charitable bequest, it reduces the "real value" of that bequest and therefore reduces the marital or charitable deduction under Sections 2055 and 2056. See *United States* v. *Stapf*,

[6] Treasury regulations define "administration expenses" as "such expenses as are actually and necessarily, incurred in the administration of the decedent's estate; that is, in the collection of assets, payment of debts, and distribution of property to the persons entitled to it." 26 C.F.R. 20.2053-3(a).

375 U.S. at 126 (the value of a marital bequest that is subject to an encumbrance must reflect the "net economic interest received by the surviving spouse").

As the court of appeals stated in *Ballantine* v. *Tomlinson*, 293 F.2d at 312-313:

> At the decedent's death his estate had the obligation of paying estate taxes, debts, charges and expenses of administration. * * * It follows then that the legacy to the decedent's spouse * * * was charged, at his death, with a like part of the expenses of administration, even though the amount of such expense might not be then ascertainable.

Accord *Alston* v. *United States*, 349 F.2d 87, 88 (5th Cir. 1965); *Estate of Roney* v. *Commissioner*, 33 T.C. at 804 (fact that administration expenses are paid from post-death income does "not relieve the residuary legacy, for valuation purposes, of that burden or encumbrance for such expenses which existed at the time of death"). Chief Judge Nies correctly stated for the court in *Burke* v. *United States*, 994 F.2d at 1581 (footnote omitted), that:

> when a decedent dies, a finite amount known as the gross estate is legally created. Any deductions for expenses incurred in administering the estate are theoretically derived from this amount and, regardless of the actual source of payment, must be accounted for within the gross estate.
>
> * * * * *
>
> Section 2051 defines the taxable estate and the deductions used to determine the taxable estate in terms of the gross estate. * * * Likewise,

section 2053, by its plain language, defines the deduction for administrative expenses in terms of the gross estate. Reading sections 2031, 2051, and 2053 together, the gross estate, which is the value of the decedent's estate at the time of death, is the sole source from which the administrative expenses may be deducted. Thus, the deduction of administrative expenses as provided for by federal law—as opposed to the actual payment of administrative expenses as allowed under state law—must come from, i.e., be accounted for within, the gross estate.

b. In the present case, however, the courts below disregarded the case law that had consistently held that administration expenses are an encumbrance on the gross estate that exists at the date of death. Instead, they reasoned that, because "[a]dministration expenses are incurred and accrue during administration" (Pet. App. 6a, 39a), these expenses "may relate to both income and corpus" and "logically can be charged to either" (*id.* at 10a, 42a).

The fact that administration expenses are inevitably incurred after the date of death, however, is not relevant in determinining the "real value" of the marital and charitable bequests on the date of death. On the date of death, the marital and charitable bequests in this case were subject to the requirement that, when administration expenses were thereafter incurred, they would be paid from those bequests. At the date of decedent's death, the estate (and, in particular, the marital and charitable bequests) could not be transferred without incurring and paying administration expenses. Administration expenses represent an encumbrance on the gross estate, and on

the marital and charitable bequests that are burdened by the obligation of paying such charges, for they must be paid before the property of the estate may be transferred.

When, as in this case, administration expenses are an "encumbrance or obligation" (26 U.S.C. 2056(b)(4)(B)) on the marital and charitable bequests, the costs incurred in disposing of that obligation must be subtracted from the gross value of those bequests to determine the "real value" or the "net economic interest received by the surviving spouse" and charity (*United States* v. *Stapf*, 375 U.S. at 126). If estate income to which the marital or charitable recipient is otherwise entitled is used to pay such administration expenses, the value of the marital and charitable bequests has, to the extent of those payments, been "acquired by purchase and not by bequest," and the marital and charitable deductions must be reduced accordingly (S. Rep. No. 1013, *supra*, Pt. 2, at 6). See page 22, *supra*.

c. Economic logic and common sense dictate the same conclusion. The "value" of property left as a bequest includes, as one of the sticks in the bundle of rights, the right to receive the stream of income derived from that property. If, however, that income is severed and must be used to pay expenses of the estate, the "real value" (*United States* v. *Stapf*, 375 U.S. at 126) of that property to the legatee is correspondingly diminished.

Consider, for example, an estate with a gross value of $1,000,000 on the date of death, $100,000 of which is to pass to a specified heir, with the residuary interest to pass equally to a surviving spouse and a charity. Assume that, as in the present case, the expenses

of administration are charged against the residuary estate. Assume further that administration expenses of $50,000 are incurred and paid on the first anniversary of the decedent's death. In order to pay those administration expenses, the executor could set aside a portion of the residuary estate on the date of death and pay the expenses from that severed portion when the expenses come due. That would, of course, directly diminish the "value" of the residuary interest on the date of death. The "value" of the residuary interest on the date of death is thus not $900,000 but is $900,000 *less* the funds that, if set aside on that date, would pay the administration expenses as they come due.

This same conclusion holds if, instead of segregating the residuary "corpus" for that purpose, the executor thereafter takes part of the earnings of the corpus to pay the administration expenses. In either case, the present or "real value" (*United States* v. *Stapf*, 375 U.S. at 126) at the date of death of the property that ultimately passes to the spouse and the charity is less than the unencumbered sum of $900,000 as of that date. Because the value of the residuary estate that passes to the spouse and charity is encumbered by the obligation to pay administration expenses, the expenses incurred in meeting that obligation must be subtracted from the theoretical, unencumbered value of the property in determining the proper amount of the marital deduction. See 26 U.S.C. 2056(b)(4)(B); *Burke* v. *United States*, 994 F.2d at 1581; *Estate of Street* v. *Commissioner*, 974 F.2d at 726.

As the Fifth Circuit stated in *Alston* v. *United States*, 349 F.2d at 89:

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * *" as argued by the executors.

3. a. Treasury regulations have long mandated this same conclusion. The regulations specify that any "material limitation" on the right of a spouse to receive income earned by the corpus of the marital bequest reduces the "value" of that bequest and therefore commensurately reduces the marital deduction under Section 2056(a). 26 C.F.R. 20.2056(b)-4(a). The regulations illustrate that principle by an example that directly governs the present case (*ibid.*):

> An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

This regulation was adopted in 1958 (T.D. 6296, 1958-2 C.B. 432, 568). It is virtually identical to the original regulation that was promulgated in 1949, the year following enactment of the statute (14 Fed. Reg. 2623, 2634 (1949)).

As Judge Dubina noted in his dissent in this case (Pet. App. 22a), and as the Fifth Circuit explained in *Ballantine* v. *Tomlinson*, 293 F.2d at 313, the Com-

missioner's interpretation of Section 2056 is directly supported by the legislative history of the statute. That history specifies that, when the spouse directly pays, or "estate income is used to pay, claims against the estate," the marital deduction must be reduced by the amount of such payments.[7] S. Rep. No. 1013, *supra*, Pt. 2, at 6; see page 22, *supra*. The regulation is also directly supported by the conclusion of this Court in *United States* v. *Stapf*, 375 U.S. at 126, that the costs imposed by burdens placed upon a marital bequest must be subtracted from the gross value of the bequest "to arrive at the real value of the gift" for purposes of the marital deduction.

b. The Tax Court sought to belittle the significance of this regulation, stating that it is "merely a valuation provision" (Pet. App. 40a). The court stated that the payment of administration expenses from income does not result in a "material" impairment of the right of the marital bequest to receive income if the amount of such expenses is "insubstantial" in comparison to the amount of the income (*id.* at 42a).[8]

---

[7] As Judge Dubina noted (Pet. App. 22a), and as the Fifth Circuit held in *Ballantine* v. *Tomlinson*, the term "claims" in this legislative history necessarily encompasses administration expenses: "The reason for including the one applies to the other." 293 F.2d at 313. See also *Estate of Street* v. *Commissioner*, 974 F.2d at 728; *Estate of Horne* v. *Commissioner*, 91 T.C. 100, 109-110 (1988); *Estate of Roney* v. *Commissioner*, 33 T.C. at 805; Rev. Rul. 73-98, 1973-1 C.B. 407.

[8] The Tax Court also suggested (Pet. App. 41a) that, in Revenue Ruling 69-56, 1969-1 C.B. 224, the Treasury had ruled that an obligation placed on a marital bequest to pay administration expenses does not result in "diminution of the marital deduction." That ruling, however, expressly addressed only whether "the *inclusion of such powers* or directions *in the governing instrument* * * * [would] result in the disallowance or diminution of the marital deduction." *Ibid.* (emphasis added). It did not, as the Tax Court implied, address whether the actual payment of such administration expenses out of the corpus or income of the marital bequest would require a reduction in the marital deduction. Since the enactment of Section 2056(b)(4)(B) in 1948, however, the applicable Treasury regulations have consistently and expressly provided that, when "the income from the property * * * is to be used to pay expenses incurred in the administration of the estate," the marital deduction must be reduced by the amount of such payments. 26 C.F.R. 20.2056(b)-4(a).

The court stated that the administration expenses involved in this case were "insubstantial" and therefore did not effect a "material" impairment of the right to receive income within the meaning of the regulation (*ibid.*).

The regulation, however, specifies that the marital deduction must be reduced whenever administration expenses have been paid from post-death income, regardless of the exact amount of the expenses in relation to the income. See *Estate of Street* v. *Commissioner*, 974 F.2d at 728 ("The example set forth in the regulation states that income used to pay the expenses of administration must reduce the size of the marital deduction"); *Fisher* v. *United States*, 28 Fed. Cl. 88, 93 (1993). Under the plain text of the regulation, it is the burden of paying administration expenses *itself* that constitutes the "material" limitation on the right of the marital bequest to receive the income from the estate. By any logical reckoning, moreover, the administration expenses involved in this case were far from "insubstantial," for they exceeded $2,000,000 (Pet. App. 3a).

c. The Tax Court also erred in stating (Pet. App. 39a) that the amount of the permissible federal estate

tax deductions depends on whether state law permits administration expenses to be charged to post-death income. Although state law defines the nature of property rights, federal law determines the manner and extent to which such rights are taxed. *Morgan* v. *Commissioner*, 309 U.S. 78, 80 (1940); *Burnet* v. *Harmel*, 287 U.S. 103, 110 (1932); *Burke* v. *United States*, 994 F.2d at 1580; *Murray* v. *United States*, 687 F.2d 386, 392 n.3 (Ct. Cl. 1982). As this Court explained in *Lyeth* v. *Hoey*, 305 U.S. 188, 194 (1938):

> In dealing with the meaning and application of an act of Congress enacted in the exercise of its plenary power under the Constitution to tax income and to grant exemptions from that tax, it is the will of Congress which controls, and the expression of its will, in the absence of language evidencing a different purpose, shall be interpreted "so as to give a uniform application to a nationwide scheme of taxation." Congress establishes its own criteria and the state law may control only when the federal taxing act by express language or necessary implication makes its operation dependent upon state law [citations omitted].

In the present case, the relevant Sections of the Internal Revenue Code do not "by express language or necessary implication make[] its operation dependent upon state law" (*ibid.*). Instead, as the Federal Circuit explained in *Burke* v. *United States*, 994 F.2d at 1581, "[a]lthough section 2053 permits state law to determine what admininistrative expenses are 'allowable,' how section 2053 treats the allowable administrative expenses for estate tax deduction purposes is a federal question." See also *Estate of Street* v. *Commissioner*, 974 F.2d at 728.

The question in this case does not turn on how the executor has allocated the expenses or on how state law permits such expenses to be allocated. Instead, it turns on how the burden of paying such expenses—either from the corpus or income attributable to the bequest—affects the "value" of the bequest at the date of death and thus the permissible marital and charitable deductions. 26 U.S.C. 2055(d), 2056(a).

d. The Treasury's interpretation of the governing federal statutes is entitled to substantial deference. As this Court stated in upholding another portion of this same regulation in *United States* v. *Stapf*, "[t]his Court has frequently 'given considerable and in some cases decisive weight to . . . interpretative Regulations of the Treasury and of other bodies that were not of adversary origin.'" 375 U.S. at 127 n.11, quoting *Skidmore* v. *Swift & Co.*, 323 U.S. 134, 140 (1944). Moreover, when "a Treasury Regulation * * * is supported by declarations of congressional intent," it "is particularly persuasive" (*ibid.*). In the present case, the applicable legislative history—like the regulation—contains a plain statement that, when estate income is used to pay burdens imposed on the marital bequest, the value of the bequest must be reduced by the amount of such payments (S. Rep. No. 1013, *supra*, Pt. 2, at 6). See 26 C.F.R. 20.2056(b)-4(a).

In *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476 (1979), quoting *United States* v. *Cartwright*, 411 U.S. 546, 550 (1973), quoting *United States* v. *Correll*, 389 U.S. 299, 307 (1967), the Court noted that it:

> customarily defers to the regulation, which "if found to 'implement the congressional mandate in some reasonable manner,' must be upheld."

The applicable regulation adopted by the Treasury under Section 2056(b)(4)(B) represents a contemporaneous and "reasonable" interpretation of the statute. The regulation therefore "deserves deference" in this case (*Smiley* v. *Citibank (South Dakota), N.A.*, No. 95-860 (June 3, 1996), slip op. 9.[9]

Moreover, even if an ambiguity were thought to exist, the estate cannot prevail simply by "casting some doubt on the proper construction of the statute." *United States* v. *Stewart*, 311 U.S. 60, 71 (1940). As this Court has frequently stated (*New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934)):

> Whether and to what extent deductions shall be allowed depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed.

Accord *Deputy* v. *DuPont*, 308 U.S. 488, 493 (1940). Statutory provisions that authorize deductions are to be "construed narrowly," and any ambiguity in their application is to be resolved against the asserted deduction. *United States* v. *Stewart*, 311 U.S. at 71.

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[9] Deference is afforded to the Commissioner's interpretation of the internal revenue laws because (*National Muffler Dealers Ass'n* v. *United States*, 440 U.S. at 477):

> "Congress has delegated to the * * * Commissioner [of Internal Revenue], not to the courts, the task of prescribing 'all needful rules and regulations for the enforcement' of the Internal Revenue Code. 26 U.S.C. § 7805(a)." *United States* v. *Correll*, 389 U.S. at 307. That delegation helps ensure that in "this area of limitless factual variations," *ibid.*, like cases will be treated alike. It also helps guarantee that the rules will be written by "masters of the subject," *United States* v. *Moore*, 95 U.S. 760, 763 (1878), who will be responsible for putting the rules into effect.

See also *Commissioner* v. *Schleier*, 115 S. Ct. 2159, 2163 (1995).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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In The

Supreme Court of the United States

October Term, 1995

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA) N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

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QUESTION PRESENTED

Whether payment of some of the post-mortem estate administration expenses out of post-mortem income of an estate reduces the value of date-of-death corpus actually passing to charitable and marital beneficiaries under 26 U.S.C. §§ 2055 and 2056, when payment from post-mortem income is permitted by state law and the controlling testamentary documents.

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OPINIONS BELOW

The opinion of the United States Court of Appeals for the Eleventh Circuit (CIR Pet. at 1a-23a)[1] is reported at 63 F.3d 1083. The reviewed opinion of the United States Tax Court (CIR Pet. at 26a-79a) is reported at 101 T.C. 314.

STATEMENT OF JURISDICTION

The judgment of the court of appeals affirming the reviewed decision of the Tax Court was entered on September 12, 1995. Petitioner ("the Commissioner") filed a petition for rehearing with suggestion for rehearing en banc on October 27, 1995, which was denied on December 5, 1995. (CIR Pet. at 24a-25a.) The Commissioner then filed a petition for a writ of certiorari on March 1, 1996, which was granted on April 29, 1996. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

In addition to those cited in the Commissioner's brief (at 2-5):

1. 26 C.F.R. §§ 20.2056(b)-5(f) provides in relevant part:

> **Marital deduction; life estate with power of appointment in surviving spouse.** . . . (f) *Right to Income.* (1) If an interest is transferred in trust, the surviving spouse is "entitled for life to all of the income

---

1. Citations to "CIR Pet." or to "CIR Br." are to the self-contained appendix in the Petition for a Writ of Certiorari or to the Brief on the merits, respectively, for Petitioner Commissioner of Internal Revenue. Citations to "Jt. App." are to the Joint Appendix of the parties filed simultaneously with the Commissioner's Brief on the merits.

from the entire interest or a specific portion of the entire interest," . . . if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust . . . .

(4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest passing in trust [for want of entitlement to "all of the income"] unless the grant of powers evidences the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest passing in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus. . . .

2. 26 C.F.R. § 25.2523(e)-1(f) provides in relevant part:

> **Marital deduction; life estate with power of appointment in donee spouse** . . . . (f) *Right to Income.* (1) If an interest is transferred in trust, the donee spouse is "entitled for life to all of the income from the entire interest or a specific portion of the

entire interest," . . . if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust . . . .

(4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest transferred in trust [for want of entitlement to "all of the income"] unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations will not disqualify the interest transferred in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus . . . .

STATEMENT OF THE CASE

This case concerns the estate tax liability of the Estate of Otis C. Hubert, who was a resident of Georgia at his death. He died in July of 1986, leaving an estate divided almost equally between his family and charity. (CIR Pet. at 3a.)

1. Upon the death of a decedent who has sufficient property value to invoke the estate tax, his "gross estate," less various

deductions, is subject to tax. 26 U.S.C. § 2001.[2] The amount of the gross estate is determined by the value of the decedent's property "at the time of his death." § 2031. Congress chose to permit bequests to charity and to the decedent's surviving spouse to pass free of estate tax and therefore provided deductions from the gross estate known as the "charitable deduction" and the "marital deduction." The measure of these deductions is the value of the property passing to charity and to the surviving spouse as of the date of the decedent's death. §§ 2055(a), 2056(a). In determining these values, neither the date-of-death value of the property going into an estate nor the date-of-death value of that same property going out of an estate is embellished by post-death income of the estate. Such values would then no longer be "date-of-death." *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941); *Bull v. United States*, 295 U.S. 247, 256-257 (1935). The object of these date-of-death valuations is to provide a uniform standard for measuring the property that comes into the estate and the property that leaves the estate, providing symmetry from an inclusion and deduction standpoint.

2. Mr. Hubert's Will left the residue of his estate in trust, the income of which was to be paid to his wife, with the remainder to charity. One of three codicils removed a general power of appointment that had been granted to Mr. Hubert's wife in his Will. That codicil led to a Will contest. After four years of litigation among Mr. Hubert's family, his nephew (who drafted the Will and codicils) and statutory representatives of the charitable beneficiaries, the Cobb County Probate Court entered an Order which disposed of the residuary estate in a manner different than the Will and codicils. In lieu of the Will and codicils, the Order implemented the Second and Final Settlement Agreement, dividing the entire residuary estate into

2. Hereafter, except as otherwise stated, all citations to "§" are to the Internal Revenue Code of 1954, 26 U.S.C., as amended and effective for decedents dying in July of 1986, and all citations to "Reg. §" are to the Treasury Regulations on Estate and Gift Tax, 26 C.F.R.

two parts (the "Marital Share" and the "Charitable Share") and designating a specific amount of residuary to be paid to the Marital Share, with the remainder flowing to the Charitable Share under a "pour-over" provision. Thus, the entire residuary went to either the Marital Share or the Charitable Share. The Marital and Charitable Shares included both estate corpus in existence as of the date-of-death and post-death income earned on that corpus. Just as post-death income had been allocated between the two Shares by agreement among adverse parties, so also were post-death administration expenses allocated between the Marital and Charitable Shares. The date-of-death value of the residuary corpus to be divided between the Marital Share and the Charitable Share was $26,224,436. (Jt. App. at 39¶50, 52¶22.)

Under Georgia probate law, an executor may charge payments of administration expenses either against the income of the estate or against corpus, if the Will so provides. GA. CODE ANN. § 53-15-3 (MICHIE 1982). In this case, Mr. Hubert's Will authorized the executor "to charge any expenses against income or principal or apportion the same." Acting pursuant to this authority in the Will, the executor charged $506,989 of administration expenses against corpus, and as permitted by § 2053(a)(2), those charges were deducted from the gross estate on the estate tax return. All other administration expenses were charged by the executor against the post-death income earned by the Hubert Estate. As permitted by the Internal Revenue Code, the executor elected to relinquish the deduction of those administration expenses against corpus on the estate tax return and instead deducted those administration expenses from post-death income on the estate's income tax returns (Forms 1041). §§ 212, 642(g).[3]

3. The Commissioner states that between 1986 and 1991, the Estate's income exceeded $4.5 million and that the Estate's administration expenses exceeded $2 million. (CIR Br. at 8.) That assertion is both misleading and inaccurate. In fact, the Estate's Forms 1041 for the years ended May 31, 1987 (Cont'd)

In accordance with the dictates of §§ 2055(a), 2056(a) and 2053(a)(2), the executor of the Hubert Estate reduced the amount of the marital and charitable deductions claimed on the estate tax return by the amount of administration expenses charged against corpus, since those expenses reduced the amount of the date-of-death corpus which the beneficiaries actually received. Because administration expenses that accrued after Mr. Hubert's death and were paid from income earned by the estate did not and could not reduce either the date-of-death valuation of the corpus included in the gross estate or the date-of-death corpus which the beneficiaries actually received, the executor did not make such a reduction for the administration expenses charged against post-death income. Instead, the executor deducted those expenses on the estate's income tax returns pursuant to §§ 212 and 642(g).

3. After issuing a notice of estate tax deficiency on grounds not before this Court, the Commissioner raised a new issue on the eve of the Tax Court trial setting. She contended that the marital and charitable deductions had been overstated by the total administration expenses, without regard to the source of their payment, the effect of state law or the effect of any elections made by the executor. Thus, the Commissioner contended that administration expenses properly paid from estate income reduced the date-of-death values of the charitable and marital bequests. Because this new issue was not set forth in the notice of estate tax deficiency, the Commissioner bore the burden of proof on all factual matters, including the effect, if any, on value of payment of administration expenses with post-death income of the estate. TAX COURT RULES OF PRACTICE & PROCEDURE 142(a).

Pursuant to Rule 91, TAX COURT RULES OF PRACTICE &

(Cont'd)
through May 31, 1990 (the last return filed prior to the Stipulation of Facts), which are part of the Tax Court record, show income of $5,207,865 and administration expenses of $1,140,114, a spread of over $4 million.

PROCEDURE, all parties must stipulate all fact matters to the fullest extent possible; "[t]he Court will not permit a party to a stipulation to qualify, change, or contradict a stipulation in whole or in part . . . ." Based upon the date-of-death values, the residuary estate was $26,224,436 (Jt. App. at 39 ¶ 50, 52 ¶ 22):

Gross Estate	$30,254,219
Specific Bequests:	
Spouse	(220,747)
Churches	(400,000)
Other	(30,000)
Schedule J Deductions (Administration Expenses)	(506,989)
Schedule K Deductions (Debts)	(2,472,047)
Estate Tax	(400,000)[4]
Total Residuary Estate (Corpus)	$26,224,436

The Commissioner's stipulations, when adjusted for the imputed interest argument she lost and did not appeal, result in the sum of the marital and charitable deductions exceeding the whole of the residuary. As corrected for the implicit issue she lost, the Commissioner stipulated that the "Allowable Residuary Marital Deduction" and the "Charitable Deduction per [the Commissioner]" were (Jt. App. at 42 ¶ 57, 43 ¶ 58):[5]

4. Because of an uncontested change in the marital deduction QTIP election, a portion of the taxes paid on the estate tax return may be subject to refund and taxed instead in Mrs. Hubert's estate. Any refund would increase the residuary and be divided between the Marital and Charitable Shares.

5. The actual stipulations were that the marital deduction was $11,896,597 and the charitable deduction was $11,840,385 flowing from the residuary. In these stipulations, the Commissioner reduced the marital and charitable deductions by interest she deemed had been implicitly earned on the assets of Mr. Hubert's estate — by $2,847,541 and $3,098,001, respectively. The Tax Court refused to condone the Commissioner's concept of imputed interest , and the Commissioner did not appeal this determination.

"Allowable Residuary Marital Deduction"	$11,896,597
Reversal of Implicit Interest Adjustment	2,847,541
Allowable Residuary Marital Deduction (Corrected)	$14,744,138
Charitable Deduction Per [the Commissioner]	$11,840,385
Reversal of Implicit Interest Adjustment	3,098,001
Charitable Deduction Per Commissioner (Corrected)	$14,938,386

Since the sum of the parts exceeds the whole, that is, the sum of the $14,744,138 marital and $14,938,386 charitable deductions exceeds the $26,224,436 date-of-death residuary corpus, the Commissioner here seeks guidance from this Court on a position which will have no financial impact upon this tax case.

The Commissioner's position was that as a matter of law, the executor must be viewed as having charged expenses against corpus as of the date of death, thereby reducing the value of the

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However, the proper amount of the date-of-death residuary corpus flowing to the Marital Share is calculated as follows (Jt. App. at 35¶43, 36¶44, 42¶57):

Second and Final Settlement	*Calculation*
¶10a.(1)	$ 14,390,000
¶10a.(1) and 17(a)	183,175
¶10a.(2)	699,376
Subtotal Marital Share	$ 15,272,551
Reductions:	
¶10a.(1)(B) (Marital Income)	($ 1,219,603)
¶10a.(2) (Marital Income)	(699,376)
Deduction – Corpus	$ 13,353,572

(Cont'd)

passing property dollar-for-dollar by the entire amount of the administration expenses. In this Court, the Commissioner puts a different spin on this position, urging that in order to determine the "real value" of the charitable and marital bequests, the date-of-death value of this property must be reduced dollar-for-dollar for estate distribution purposes (although not for inclusion purposes) by the full amount of any expenses ultimately paid with income. (CIR Br. at 19.) Nevertheless, the Commissioner put on no evidence whatsoever of the effect on the date-of-death value of the residuary property passing to the spouse and to charity resulting from the contingent event that the executor might charge administration expenses against corpus. Nor did the Commissioner put on any evidence as to the effect of this contingency on the date-of-death value of that same property for estate inclusion purposes.

4. The en banc Tax Court held that the marital and charitable deductions were not reduced by post-death administration expenses properly allocated to post-death income pursuant to Georgia law and Mr. Hubert's controlling testamentary documents. (CIR Pet. at 50a.) The Commissioner had relied primarily on permissive language in a marital deduction valuation regulation which listed payment of administration expenses from income as an example of an instance in which an encumbrance might exist on a marital bequest. Reg. § 20.2056(b)-4(a). Although the Commissioner read the regulation as an inviolate rule, the Tax Court opined that

(Cont'd)

The remainder of the residuary corpus (excluding post-death income) passes to the Charitable Share by way of a pour-over provision. The amount of that corpus is (Jt. App. at 35-36¶44, 43¶58):

Date-of-Death Residuary — Corpus	$ 26,224,436
Allocated to Marital — Corpus	(13,353,572)
Balance to Charity — Corpus	$ 12,870,864

it merely set forth a permissive example of a situation in which the rule *may* be applied, if the proof of value shows that it is factually applicable. Based on the facts of the case, the Tax Court found that the right to pay administration expenses out of post-death income was not a material limitation on the right of the surviving spouse to receive that income. (CIR Pet. at 40a-41a.) The Commissioner did not appeal this fact-finding.

Further, the Tax Court pointed out that the regulation relied upon by the Commissioner, as well as its statutory origins, directed that the value of the interest passing to the spouse, if encumbered, be determined "as if the amount of a gift to the spouse were being determined." (CIR Pet. at 41a.) The Tax Court pointed out that the Commissioner's own gift tax rulings had long held that payment of administration expenses out of income is not a limitation on the spouse's right to income. Further, on the facts of this case, the Tax Court found that no substantial limitation on Mrs. Hubert's right to income existed, a fact-finding which the Commissioner has not appealed. (CIR Pet. at 41a, *citing* Rev. Rul. 69-56, 1969-1 C.B. 223.)

This reading is the only one which harmonizes all of the Commissioner's regulations, including Reg. § 20.2056(b)-5(f)(4), with the governing statute. This regulation addresses the marital deduction when, as here, the spouse receives a life estate with a general power of appointment,[6] and it specifically addresses the "right to income" when the executor is given the discretion to pay expenses out of income. The regulation states that "the power to determine the allocation or apportionment of receipts and disbursements between income and corpus" is not a condition which will cause the spouse to have a right to less than

6. Under the settlement agreement, the Marital Share is divided between the general power of appointment trust and a qualified terminal interest trust. Principles identical to those contained in Reg. § 20.2056(b)-5(f)(4) are applied to a qualified terminal interest trust by Reg. § 20.2056(b)-7(d)(2).

"all of the income," as required by a general power of appointment trust, "if the local courts will impose reasonable limitations upon the exercise of powers." (CIR Pet. at 42a.) Those "reasonable limitations" exist under Georgia law. *Citizens & Southern Nat'l Bank v. Haskins*, 254 Ga. 131, 327 S.E.2d 192 (1985).

The Tax Court also rejected the Commissioner's contention that the legislative history of the marital deduction dealing with payment of claims out of an estate's post-death income requires a reduction of the marital deduction when administration expenses are paid out of that income. (CIR Pet. at 42a.) This legislative history nowhere refers to administration expenses. The Tax Court pointed out that claims against an estate are in existence at the date of death and thus burden the estate's corpus, but administration expenses arise after death and may relate to both corpus and post-death income. Logically, administration expenses may thus be charged to either post-death income or to corpus, while claims must be charged to corpus.

The Tax Court expressly disagreed with the contrary prong of the Sixth Circuit's decision in *Estate of Street v. Commissioner*, 974 F.2d 723, 727 (6th Cir. 1992), *aff'g in part and rev'g in part*, 56 T.C.M. (CCH) 774 (1988).[7] (CIR Pet. at

7. *Estate of Street* had two parts: (i) with respect to interest on estate taxes, the court held that such administration expenses, when allocable to post-mortem income, do not reduce the marital and charitable deductions because the interest expense accrues after death, and estate income used to pay these expenses would not affect the date-of-death value of the estate; (ii) with respect to other post-mortem administrative expenses, allocable to income, the charitable and marital deductions would be reduced dollar-for-dollar because of the example set forth in Reg. § 20.2056(b)-4(a). 974 F.2d at 729. The Commissioner has now agreed with the *Estate of Street* position as to interest on estate taxes. Rev. Rul. 93-48, 1993-2 C.B. 270. Whether other administration expenses can be differentiated from estate tax interest expenses is the subject of this case. Rev. Rul. 79-252, 1972-2 C.B. 233.

46a.) The Tax Court disagreed with the Sixth Circuit's analysis that income earned by the estate increases the Marital Share and so expenses paid out of that income must reduce the marital deduction. That analysis proceeds on the false assumption that the Marital Share and the marital deduction are one and the same. Consistent with this critical factual distinction established by the Tax Court in its first footnote (CIR App. at 27a n.1), the Marital Share includes both the date-of-death corpus and post-mortem income, whereas the marital deduction only includes the date-of-death corpus. The Tax Court noted that income earned on estate property is not included in the gross estate, and "as a result, under section 2056(a), such income does not lead to an increase in the amount of the marital deduction requiring a corresponding decrease for payment of administration expenses chargeable against income of the estate." (CIR Pet. at 46a-47a.)

5. The court of appeals adopted the Tax Court's opinion as its own. (CIR Pet. at 1a-23a.) In doing so, the court of appeals noted that Georgia law authorizes the allocation of expenses to income, rather than principal, if the Will so provides. For this reason, the court reconciled and embraced prior precedents, which also followed the requirements of state law with respect to whether administration expenses should be charged against corpus. *Alston v. United States*, 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner*, 294 F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson*, 293 F.2d 311, 312-313 (5th Cir. 1961). Finally, the court of appeals noted that the Fifth Circuit (the author of these three opinions) agreed with the Tax Court. In *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993), the Fifth Circuit held that the allocation of administration expenses to income as allowed by state law does not reduce the charitable deduction. (CIR Pet. at 2a-3a.)

SUMMARY OF ARGUMENT

This federal estate tax dispute focuses upon the division of the corpus of the residuary estate between the surviving spouse

and charity. There is no dispute as to the amount of the date-of-death value of the residuary corpus, for that is uncontroverted. Nor is there any dispute that, in determining this corpus, the Hubert Estate properly allocated a portion of post-mortem administration expenses to corpus and properly allocated the remainder to post-mortem income under the authority of the controlling testamentary documents and state probate law: that is stipulated. There is also a stipulation that the Second and Final Settlement Agreement (which settled a four-year Will contest) is binding here for federal estate tax purposes. Finally, there is no dispute that this agreement controls the actual flow of the residuary property and divides the entire residuary corpus between the surviving spouse and charity. The Commissioner simply wishes to create a disappearing residuary by way of a federal fiction that $26,224,436 of corpus comes into the residuary but only $24,294,375 goes out to the surviving spouse and to charity. The Commissioner then seeks to tax this disappearing residuary. As 15 out of 17 Tax Court judges and the majority of the United States Court of Appeals for the Eleventh Circuit held, that attempt is flawed for at least seven reasons:

1. The sum of the parts should equal the whole of the residuary corpus. The federal estate tax system is built upon a concept of symmetry, by measuring the property coming into an estate under the same standards that it measures property flowing out of the estate. For both inclusion and distribution purposes, the federal estate tax system uses fair market value as of the date of the decedent's death. In this way, what comes in goes out: the estate balances.

2. In order to be true to this standard, one cannot succumb to the temptation to indulge in hindsight. Both the Tax Court and the Eleventh Circuit relied upon this Court's directive in *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941), for the critical principle that post-mortem income earned by the estate cannot

enhance the date-of-death value of property coming into the gross estate. *Accord, Bull v. United States*, 295 U.S. 247, 256-257 (1935). It follows that since post-mortem income makes up no part of the gross estate and since the gross estate is the starting point for computing deductions to arrive at the taxable estate, post-mortem expenses paid from that post-mortem income under the authority of the Will and state law cannot decrease what has not been increased — the date-of-death value of the corpus.

3. The conclusion reached by the Tax Court and the court of appeals is the only result consistent with the overriding purposes of the charitable and marital estate tax deductions. Since 1981, the purpose of the marital deduction has been to permit a deferral of estate tax on property passing to the surviving spouse until the death of the second spouse, recognizing that husband and wife constitute a single "economic unit." Hence, Congress provided for a full marital deduction with the expectation that there would generally be no tax on the first estate. By comparison, Congress has always encouraged charity by excluding charitable contributions from estate tax. If a generous citizen leaves his or her entire estate to charity, Congress intended that the charity should receive that entire estate with no diminution by federal estate taxes. Likewise, if a citizen divides his or her estate entirely between charity and the surviving spouse, no tax is ever incurred on the part left to charity, and the tax on the part left to the spouse is deferred until her death. Thus, the Commissioner's position in this case is an attempt to create tax when none was intended by Congress by exploiting the delays caused by the Will contest and this tax litigation.

4. The Commissioner successfully urged reliance on state probate law in the three cases on which all of the appellate authority in this area is based, since state law operated to her financial advantage in those cases. *Alston v. United States*, 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner*, 294

F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson*, 293 F.2d 311, 312-313 (5th Cir. 1961). In each of those cases, the Commissioner argued that state law determined whether date-of-death corpus or post-mortem income bore the obligation of post-mortem administration expenses. Once the flow of property was determined, federal law was applied. Now the Commissioner wants to change her mind. However, only her original approach can be reconciled with the 40 years of precedent on this issue. Indeed, every commentator post-*Estate of Hubert*, save a student note, has concluded that the Tax Court and the Eleventh Circuit are correct.

5. The federal estate tax and income tax treatment endorsed by the Estate, the Tax Court and the Eleventh Circuit is also buttressed by the reality that such treatment is precisely what the Commissioner would require had the Estate been able to promptly close into trusts. The delay caused by the period of administration simply does not change date-of-death values.

6. For the first time in the eight-year history of this case, the Commissioner places her primary reliance on a "real value" argument, citing a case not urged by her in her Petition for Certiorari or even cited by the courts below. The case cited by the Commissioner, *United States v. Stapf*, 375 U.S. 118 (1963), is a *quid pro quo* case and has no application to the question before this Court. *Stapf* applies only to "obligations" or "encumbrances" imposed by the decedent which result in a purported legatee having to effectively purchase property from the estate. Post-mortem administration expenses properly borne by post-mortem income create no obligation or encumbrance on corpus within the meaning of §2056(b)(4)(B). Moreover, the gift tax standards invoked by that statute recognize that costs of administration may be borne by income when adequate allocation protection is afforded by state law. Finally, the Commissioner's new interpretation of a 40-year-old regulation, one that conveniently ignores the permissive nature of the

example contained therein, is entitled to no deference from this Court.

7. The essence of the Commissioner's new position is a valuation dispute, which is inherently a factual matter. Challenge of the Tax Court's fact-findings is barred by the Commissioner's stipulations, her failure to introduce any evidence despite having the burden of proof, and her failure to appeal the fact-findings against her.

ARGUMENT

1. The Statutory Scheme Provides Symmetry for Valuing Property Included in and Distributed by an Estate, as Well as a Choice to Deduct Post-Death Expenses on Either the Estate Tax Return or the Estate's Income Tax Return.

The federal estate tax system proceeds on the basis of symmetry. That symmetry is achieved by including property in the gross estate using the same standard and the same valuation date as are applied against that same property upon distribution. Thus, upon the death of a decedent dying with sufficient property to invoke the estate tax, his or her "gross estate," less various deductions, is subject to that tax. §2001. The amount of the gross estate is determined by the value of the decedent's property "at the time of his death." § 2031 ("the value of the gross estate of the decedent shall be . . . the value at the time of his death"); § 2033 ("[t]he value of the gross estate shall include the value of all property . . . of the decedent at the time of his death").

To implement the congressional policy treating husband and wife as one economic unit,[8] property passing to the surviving

8. "[A] husband and wife should be treated as one economic unit for purposes of estate and gift taxes. . . ." S. Rep. No. 144, 97th Cong., 1st Sess. 127 (1981), *reprinted in* 1981-2 C.B. 412, 461.

spouse is deducted from the gross estate. § 2056(a). The measure of this "marital deduction" is the value of the property passing to the surviving spouse "as of the date of decedent's death," if the value of such property "is included in determining the value of the gross estate." § 2056(a); Reg. § 20.2056(b)-4(a). Similarly, to effect the congressional goal of encouraging charitable giving, the gross estate is reduced by charitable contributions, with the measure of those contributions being "the value of property included in the decedent's gross estate," *i.e.*, the date-of-death value. § 2055(a); Reg. § 20.2055-1(a). Again, the amount of the deduction from the gross estate for transfers to charity "shall not exceed the value of the transferred property required to be included in the gross estate." § 2055(d). The object of these date-of-death valuations is to provide a uniform standard for measuring the property that comes into the estate and the property that leaves the estate, so that symmetry from an inclusion and deduction standpoint will exist.

The death of a decedent, opening and administration of his or her estate, distribution of assets to beneficiaries, and resolution of claims is a process that often occupies a span of time. As a consequence, many estates — especially complicated estates or those drawn into litigation — will be required to file and pay income taxes on their net income during the period of administration of the estate. This requirement is set forth in Subchapter J of the Internal Revenue Code, entitled *Estates, Trusts, Beneficiaries, and Decedents.*

During the period that an estate is being administered, it will incur administration expenses. Since, for income tax purposes, Subchapter J of the Internal Revenue Code subjects estates and trusts to the provisions applicable to individuals, estates and trusts are thereby authorized to deduct administration expenses for income tax purposes. §§ 641(b), 212. The Subchapter J rules grant the estate the freedom of deducting administration expenses on the estate's income tax return (Form 1041), subject

to certain restrictions. If, as here, the administration expenses are reported on the Form 1041, the estate is reporting the same numbers in the same income tax return and on the same form it would have used had the estate been able to close promptly into trust.

First, however, to deduct administration expenses for income tax purposes, the estate's fiduciary must relinquish the right otherwise granted by §§ 2053 and 2054 to deduct those same administration expenses on the estate tax return (Form 706).[9] § 642(g). Thus, § 642(g) precludes the double deduction of the same administration expenses on both the estate's income tax return and the estate's estate tax return. Second, when estate corpus is used to pay the administration expenses (as with those estate expenses allocated to corpus in this case), that same corpus obviously cannot be used to fund the marital, charitable or any other estate tax deduction. Finally, when state law or the controlling testamentary documents create an obligation on the part of the estate to use corpus to pay those expenses, then estate corpus is viewed as actually or constructively distributed for that purpose and therefore cannot be distributed to the surviving spouse or to charity. *Alston v. United States*, 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner*, 33 T.C. 801, 804 (1960), *aff'd per curiam*, 294 F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson*, 293 F.2d 311, 312-313 (5th Cir. 1961).

The Commissioner admits that neither state law nor the controlling testamentary documents create any obligation to pay post-death administration expenses from Estate corpus. (CIR Br. at 8.) Instead, the Commissioner attempts to fashion a new

9. No dollar of double deduction occurs here either factually or legally. In addition to the factual symmetry, the language of this no-double deduction rule limits its application to amounts deductible under §§ 2053 (administrative expenses and debts) and 2054 (losses); the rule has no application to amounts deductible from the taxable estate under §§ 2055 (transfers to charity) and 2056 (transfers to surviving spouse).

limitation: after 40 years, she now says that § 2056(b)(4)(B) preempts state law governing property rights and the value of the corpus passing to the widow. That statute, says the Commissioner, provides that when post-death administration expenses are paid out of post-death income as permitted by Georgia law and the controlling testamentary documents, the expenditure of that income constitutes an "obligation" or "encumbrance" on the surviving spouse's right to income, the effect of which is to require a dollar-for-dollar reduction of the value of the corpus passing to the surviving spouse.

As to the Estate corpus passing to charity in this case, the Commissioner also admits that corpus bears no obligation under state law or the testamentary documents to pay post-death administration expenses. Nevertheless, the Commissioner fashions a non-statutory limitation on an estate's charitable deduction by contending that the Estate corpus is subject to some amorphous "obligation" to pay post-death administration expenses because income of the estate is used to pay those expenses. As is shown below, that conclusion rips the otherwise smooth fabric of the estate tax system.

2. Hindsight Plays No Part in Determining the Date-of-Death Value of Property Included in the Gross Estate and the Date-of-Death Value of Property Distributed to Marital and Charitable Legatees.

Ten years after Mr. Hubert's death, the Commissioner argues that $1 of administration expenses incurred and paid with income today somehow reduces the date-of-death value of the corpus in 1986 by that same $1. Consistent usage of a date-of-death valuation standard definitionally precludes such a futuristic examination to determine date-of-death value. Hindsight, as a valuation tool, would undermine the fundamental nature of the estate tax as an excise tax on the value of property transferred at death. As this Court was quoted in *Walter v. United*

States, 341 F.2d 182, 185 (6th Cir. 1965):

> It also must be kept in mind that the measure of the [estate] tax must be determined according to the situation as it existed on the date of the death of the decedent, and not according to the subsequent events, '[t]empting as it is to correct uncertain probabilities by the now-certain fact . . .' [*citing Ithaca Trust Co. v. United States*, 279 U.S. 151, 155 (1924)].

Accord, Trust Servs. of America, Inc. v. United States, 885 F.2d 561, 569 (9th Cir. 1989); *Estate of Lloyd v. United States*, 650 F.2d 1196, 1199 (Ct. Cl. 1981); *Estate of Gilford v. Commissioner*, 88 T.C. 38, 52 (1987).

This statutory theme of prohibition against a hindsight approach to valuation has been the decisional basis for this Court many times. As this Court held early in the life of the estate tax, income earned by an estate during its administration is not included in the gross estate, notwithstanding the fact that charity or the surviving spouse has a right to receive that income under the Will. *Maass v. Higgins*, 312 U.S. 443, 448-449 (1941); *Bull v. United States*, 295 U.S. 247, 256-257 (1935). Symmetrically, neither the marital deduction nor the charitable deduction can then be "grossed up" by income earned during the estate's administration even though that income is actually distributed to charity or the surviving spouse. Otherwise, such values would no longer be "date-of-death." *Harrison v. Northern Trust Co.*, 317 U.S. 476, 480 (1943).[10]

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10. The examples used by the Commissioner and the Tax Court dissent suffer from this defect. (CIR Pet. at 66a, 70a; CIR Br. at 27-28.) These defects are summarized in Farhad Aghdami, *Payments Out of Post-Mortem Income: Impact on Estate Tax Marital and Charitable Deductions*, 49 TAX LAW. 707, 739-740 (1996):

(Cont'd)

As a consequence, since post-death income cannot increase

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> [T]he asset Judge Halpern used in his example was a zero-coupon bond which was valued, in part, by determining the present value of the future income stream. Judge Halpern stated that since the income portion attributable to the zero-coupon bond is used to pay expenses, the marital deduction must be reduced. Assuming Judge Halpern's analysis was correct with respect to the zero-coupon bond, the same analysis does not hold true when the value of the asset is not measured by its future income stream. This point is demonstrated by the example of the $1000 certificate of deposit which has $50 of accrued income [at the date of the decedent's death]. This asset is valued in the gross estate at $1050. The income stream derived from the CD after the decedent's death is irrelevant to a determination of the value of the gross estate and the amounts of the marital and charitable deductions. At the death of the decedent, $1050 is included in the gross estate. The payment of expenses from income earned by the CD after the death of the decedent does not affect, in any way, this amount. When the CD matures, an amount of $1100 representing $1050 of principal and $50 of income is paid to the estate. The payment of a $50 administration expense from income does not, in any way, reduce or affect the principal amount of $1050.
>
> Judge Halpern's analysis fails for a second reason. When the value of an asset is measured by valuing the income stream derived from the principal, such as a zero-coupon bond, Judge Halpern stated that the marital deduction should be reduced if administration expenses are paid from the income stream. However, Judge Halpern failed to consider that the value of the asset in the gross estate, and not just the marital deduction, should be reduced to reflect the burden on the income stream.

the gross estate, neither can proper payment of estate administration expenses from post-death income decrease the amount of the estate that actually passes to charity or to a surviving spouse. To hold otherwise would contravene the statutory directive to deduct "from the value of the gross estate the amount of all bequests" to charity and to deduct "from the value of the gross estate an amount equal to the value of any interest in property which passes . . . from the decedent to his surviving spouse . . . ." §§ 2055(a), 2056(a).

3. The Holdings of the Tax Court and the Eleventh Circuit Produce the Only Result Which Is Consistent with the Purposes of the Marital and Charitable Estate Tax Deductions.

Notably, the Commissioner seeks in this case to create tax when none was intended by Congress or the decedent. To that end, the Commissioner cites the now-superseded purpose of the marital deduction of giving common law estates the same property-splitting benefits available to community property estates, in which the surviving spouse's one-half interest in the community is excluded from the decedent's gross estate by virtue of the community property system. (CIR Br. at 23.) That purpose has had no mathematical or substantive meaning since 1981. Since 1981, the purpose of the marital deduction has been entirely different. Congress chose then to recognize a married couple as a single economic unit, so that it was inappropriate to impose transfer taxes until the death of the last member of that economic unit. S. Rep. No. 144, 97th Cong., 1st Sess. 127 (1981), *reprinted* in 1981-2 C.B. 412, 461. Based upon this concept, Congress dramatically changed the federal estate tax marital deduction from the community property parity of a 50% exclusion to a 100% exclusion on the death of the first spouse. In this way, the federal estate tax burden is deferred until the closing of the economic unit — the death of the surviving spouse.

Similarly, Congress always has encouraged charity by exempting from federal estate tax all charitable contributions, recognizing that such encouragement relieves the government from meeting public needs which would fall on the shoulders of the government in the absence of charitable activity. *McGlotten v. Connally*, 338 F. Supp. 448, 456 (D.D.C. 1972), *citing* H. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938). If a citizen gives his or her entire estate to charity, the charity receives that entire estate without diminution by federal estate taxes.

Nevertheless, the Commissioner asks this Court to hold that when administration expenses are properly paid from estate income, the estate is not entitled to a charitable or marital deduction for the full amount of the gross estate that actually passes to charity and to the spouse, a departure from the congressional directive expressed in §§ 2055(a) and 2056(a) to deduct from the gross estate the date-of-death value of bequests to charity and to the surviving spouse. To illustrate, assume that the value of John's gross estate on the date of his death was $30x of corpus. During the period of estate administration, the estate earned $6x in income and incurred $4x in administration expenses. As permitted by the Will and by state law and with due regard to fiduciary duties to income beneficiaries versus remaindermen, the executor used $2x of the $30x of corpus to pay administration expenses, paying the $4x balance of the administration expenses from the $6x of post-death income earned by the corpus. Since $2x of the $30x estate corpus was used to pay administration expenses, the remaining $28x of corpus was split evenly between the surviving spouse and charity, with actual corpus distributions to each of $14x. This accounts for the entire $30x existing as of the date of death. Because the executor used $4x of the $6x post-death estate income to pay estate administration expenses, the net income of the estate was $2x, all of which was reported on the estate's fiduciary income tax returns (Form 1041). What came in, went out: the estate balanced.

In contrast, the Commissioner's position results in a hypothetical, disappearing residuary estate: despite the fact that $14x of date-of-death corpus was actually distributed to the spouse and $14x of date-of-death corpus was actually distributed to charity, the Commissioner would artificially assume that only $12x of corpus passed to each beneficiary:

	$30x	gross estate
-	2x	administration expenses paid from corpus
-	4x	expenses paid from income
	$24x	estate remaining for distribution to beneficiaries
÷	2	division of estate equally between spouse and charity
	$12x	distribution to each of spouse and charity

This view leaves $4x of corpus missing from the gross estate, yet subject to estate tax. In other words, the $30x date-of-death corpus is distributed $2x for expenses paid from corpus, $12x to the spouse and $12x to charity, for a total of only $26x. Thus, $4x of corpus disappears, but not before it is taxed.[11] This construction disregards the mandate of the marital and charitable deduction sections, which require that the full value of all property actually passing to those beneficiaries be deducted from the gross estate. §§ 2055(a), 2056(a). In order to avoid taxation of this disappearing residuary on the estate tax return, the executor is forced to move the administration expenses paid from income to the estate tax return, rather than the estate's income tax return. The resulting tax on *gross* income is an administrative repeal of the choice given to fiduciaries in

11. Worse yet, the tax on the $4x has to be paid by John's estate, which further reduces the marital and charitable deductions, which generates more estate tax, which further reduces the marital and charitable deductions, which generates more estate tax, spiraling the bequests to John's widow and charity ever downward.

§ 642(g) as to the situs of a deduction for administration expenses.[12]

"The cardinal principle of statutory construction is to save and not to destroy." *NLRB v. Jones & Laughlin Steel Corp.*, 301 U.S. 1, 30 (1937). The deliberate congressional choice to give the executor freedom in the allocation of administration expenses as between corpus and income is inconsistent with a forced and fictional allocation of administration expenses to corpus.

For these reasons, the courts below correctly decided this case. The Commissioner's construction cannot be reconciled with the express language of the Internal Revenue Code.

4. As the Commissioner Has Argued Successfully Before, State Law Determines Property Rights.

The Commissioner, for 30 years, has taken the position that whether and how the payment of administration expenses affects estate corpus passing to the surviving spouse and charity is a question of state law. *Estate of Watts v. Commissioner,* 823 F.2d 483, 485 (11th Cir. 1987); *Alston v. United States,* 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner,* 294 F.2d 774 (5th Cir. 1961); *Ballantine v. Tomlinson,* 293 F.2d 311, 312-313 (5th Cir. 1961).

In particular, state law governs apportionment of estate expenses in the form of taxes, absent contrary provisions in the

12. As well, forcing deduction of the administration expenses on the estate tax return interferes with the fiduciary's obligation to fairly apportion expenses between corpus and income beneficiaries. By definition, according to the Commissioner, all administration expenses are chargeable to corpus, a truism which has been rejected by the courts. *Estate of Warren v. Commissioner,* 981 F.2d 776, 782 n.10 (5th Cir. 1993).

Will. *Riggs v. Del Drago,* 317 U.S. 95, 98 (1942). The apportionment of estate taxes has important consequences: it can affect the actual amount of the estate tax.[13] In this context, state law controls what portion of the estate taxes must be attributed to the surviving spouse and be subtracted in determining the marital deduction. When the Eighth Circuit addressed calculation of the marital deduction, it too held, as the Tax Court did here, that the allocation of the expense (federal estate taxes) in calculating the marital deduction is controlled by state law. *United States v. Traders Nat'l Bank,* 248 F.2d 667, 669 (8th Cir. 1957).

Ironically, the Commissioner now seeks to ignore her own success in persuading the Fifth Circuit to look to state law to determine who bears administration expenses and then to apply federal law once the flow of property is defined. The result reached by the Fifth Circuit and urged by the Commissioner in the three decisions of *Alston v. United States,* 349 F.2d 87, 89 (5th Cir. 1965); *Estate of Roney v. Commissioner,* 294 F.2d 774 (5th Cir. 1961); and *Ballantine v. Tomlinson,* 293 F.2d 311, 312-313 (5th Cir. 1961) (which are the foundation for all of the appellate court cases in this area), was absolutely correct. State property and probate law has to be considered because it, as applied to the controlling testamentary documents, dictates where the property actually flows.[14] The parties have stipulated here that the property flows precisely where and how Mr. Hubert's Estate says it flows. The Commissioner now, however, seeks to abandon the

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13. An apportionment of estate taxes to a marital or charitable share decreases the amount of the deduction and thus increases the estate taxes due. Such a determination under state law is a determination of the underlying rights of the parties upon which the amount of the federal estate taxes depends.

14. The stipulation of the parties is that state law and the testamentary documents control the distributions of property in Mr. Hubert's Estate. (Jt. App. at 34 ¶ 40.)

well-established bodies of state property and probate law, which every state has, in favor of a non-existent body of federal property and probate law, even though the Commissioner championed that state law when it worked to her financial advantage in the three cited cases.[15] Mr. Hubert's Estate embraces the proposition of these cases that when administrative expenses are required by the Will or state probate law to be paid from corpus, or when the executor actually elects to pay such expenses from corpus, then the charitable and marital deductions must be reduced to reflect what those beneficiaries actually receive, as required by §§ 2055(a) and 2056(a). In fact, the court which issued these three foundational decisions has remained true to that proposition.

Estate of Warren v. Commissioner, 981 F.2d 776 (5th Cir. 1993), recognizes the controlling effect of state law on the precise issue presented here. In *Warren* the decedent's Will placed the bulk of her estate into two equal charitable lead residuary trusts. As here, Will contests were filed, and the charities filed a suit for a declaratory judgment as to how the administration expenses of the estate should be allocated between corpus and income. A settlement was reached. The administrators of the estate then asked the probate court for instructions regarding allocation of administration expenses, because, under the Texas Trust Code (like Georgia law), expenses could be charged against either income or principal. The probate court ordered that a reasonable allocation of the expenses would be 72.5% to income and 27.5% to corpus. Pursuant to that holding, the estate deducted 27.5% of the expenses on its estate tax return (Form 706) and the balance on its income tax returns (Forms 1041) — a ratio virtually identical to the ratio in this case.

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15. "[T]he rule is the rule whosoever's ox is being gored . . . [O]ur job is to assure that what was once the goose's sauce shall for the gander now be the same." *Neill v. Phinney,* 245 F.2d 645, 647 (5th Cir. 1957).

The Commissioner claimed in *Estate of Warren,* as here, that all the expenses were chargeable to corpus and none could be allocated to income. On that basis, the Commissioner reduced the charitable deduction dollar-for-dollar. However, the Fifth Circuit held that the probate court had applied state law properly in allocating the administration expenses between income and corpus and that, as a result, the administration expenses charged to income and deducted on the income tax returns did not reduce the charitable deduction. 981 F.2d at 782.

For these reasons, the Commissioner misconstrues the relationship between federal law and state law as it applies to this case. State law determines the rights and interests of the parties, while federal law determines how these interests are taxed. *Morgan v. Commissioner,* 309 U.S. 78, 80-81 (1940); *Blair v. Commissioner,* 300 U.S. 5, 9-10 (1937). Nevertheless, the Commissioner here asserts that state law should be read out of the equation whenever there is a possibility that differing results could be reached depending upon the residence of the decedent. (CIR Br. at 31-33.) This simply is not the law.[16] Whenever state law defines property and probate interests differently, the estate tax regime necessarily follows those interests, and results differ. *See, e.g., Commissioner v. Estate of Bosch,* 387 U.S. 456 (1967); *Jackson v. United States,* 376 U.S. 503 (1964); *Estate of Vissering v. Commissioner,* 990 F.2d 578 (10th Cir. 1993); *Estate of Warren,* 981 F.2d at 776; *Estate of Casey v. Commissioner,* 948 F.2d 895 (4th Cir. 1991); *United States v. Edmondson,* 331 F.2d 676 (5th Cir. 1964); *United States v. Traders Nat'l Bank,* 248 F.2d 667, 668 (8th Cir. 1957); *Hunter v. United States,* 597 F. Supp.

16. There is nothing in the Internal Revenue Code or the regulations thereunder that requires administration expenses to be paid out of corpus. *Estate of Warren,* 981 F.2d at 782 n.10. As the Commissioner admits, nothing in Georgia law requires administration expenses to be paid out of corpus. Consequently, there is no conflict between state and federal law — either on the merits or the 30-year history of federal law looking to state law with respect to the determination of property rights.

1293 (W.D. Pa. 1984); *Estate of Bennett v. Commissioner,* 100 T.C. 42, 67 (1993); *Estate of Watson v. Commissioner,* 94 T.C. 262 (1990); *Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987); *Estate of Snider v. Commissioner,* 84 T.C. 75 (1985); *Estate of Lee v. Commissioner,* 11 T.C. 141, 145-148 (1948), *acq.,* 1948-2 C.B. 3.

The Commissioner's dance to a new tune is apparent from a review of her guidance to the public. The nationwide ruling position of the Commissioner for the past 30 years has been that these matters are controlled by state law. For example, Rev. Rul. 66-21, 1966-1 C.B. 219, held that only one-half of a decedent's funeral expenses were allowable as a deduction under Texas community property law, which made half those expenses an obligation of the surviving spouse. In response, Texas changed its law, and the Commissioner accordingly ruled that funeral expenses paid after May 26, 1967 for a Texas decedent were fully deductible. Rev. Rul. 69-193, 1969-1 C.B. 222; *accord,* Rev. Rul. 76-369, 1976-2 C.B. 281. Those rulings remain in force today. Likewise, in Rev. Rul. 78-419, 1978-2 C.B. 244, and Rev. Rul. 88-12, 1988-1 C.B. 330, the Commissioner held that South Carolina law determined whether expenses and federal and state death taxes were chargeable to the marital share. The Commissioner stated (*id.* at 331; emphasis added):

> In ascertaining the net value of the interest passing to the surviving spouse for purposes of determining the allowable marital deduction, *applicable state law is determinative of the extent* to which federal and state death taxes and *debts and expenses are chargeable against the spouse's interest.*

The long history of state law determination of this issue is appropriate because this is not an issue upon which a federal

uniform standard is necessary. Congress, in drafting the Internal Revenue Code, did not intend to redefine whole areas of legal relationships created by state property law but instead sought to impose a uniform system of taxation upon the existing legal structure. *Morgan v. Commissioner,* 309 U.S. 78, 80-81 (1940); *Ernest & Mary Hayward Weir Foundation v. United States,* 362 F. Supp. 928, 932 (S.D.N.Y. 1973), *aff'd,* 508 F.2d 894 (2d Cir. 1974).

The Commissioner's attempt to substitute federal law for state law is particularly inappropriate when, as with property and probate matters, the body of state law is well developed and the body of federal law is not. As recognized in Note, *The Role of State Law in Federal Tax Determinations,* 72 HARV. L. REV. 1350, 1353 (1959) (emphasis added):

> One factor operating in favor of the application of state law is the advantage of convenience and predictability in planning. Most lawyers are accustomed to operating within the framework of *state property and probate law,* and this law is generally more settled than the comparatively recent and shifting tax legislation. If tax consequences follow local law, therefore, the tax consequences of property dispositions will be more predictable.

Thus, federal law is presumed *not* to preempt state law in inherently local areas of the law such as property rights and probate matters. *Cf., California v. FERC,* 495 U.S. 490, 497 (1990); *California v. ARC America Corp.,* 490 U.S. 93 (1989); *Paige v. Henry J. Kaiser Co.,* 826 F.2d 857 (9th Cir. 1987), *cert. denied,* 486 U.S. 1054 (1988).

Accordingly, judicial precedent, the Commissioner's own rulings, commentary,[17] and the facts of this case all support the Tax Court's recognition of substantive property rights under Georgia law. The alternative now urged by the Commissioner would create a schism between a federal fiction and the actual distribution dictated by the controlling documents and Georgia law. Uniformity of tax treatment following substantive state law would be sacrificed in favor of schisms that would vary in breadth from state to state. *Commissioner v. Stern,* 357 U.S. 39, 45-47 (1958) (constitutionally required uniformity exists even though variations in state law result in differences in tax consequences from state to state).

5. No Difference Should Exist Between an Estate Which Is Able to Promptly Distribute Its Assets into Trust and One Which Is Not.

At least one commentator has pointed out that the treatment

17. Since the Tax Court issued its thorough decision, seven of the eight articles which take a position on this issue have agreed with the Tax Court and the Eleventh Circuit. Farhad Aghdami, *Payments Out of Post-Mortem Income: Impact on Estate Tax Marital and Charitable Deductions,* 49 TAX LAW. 707 (1996); Pamela C. Champine, *Paying Administrative Expenses Out of Income Attributable to Marital and Charitable Residuary Bequests: Double Dipping or Appropriate Accounting?,* 14 VA. TAX REV. 507 (1995); Steven C. Colburn, Ted D. Englebrecht & Gloria Vollmers, *Administrative Expenses and the Marital Deduction,* 72 TAXES 412, 419 (1994); Scott H. Malin & Bennett S. Keller, *Planning for the Allocation of Administration Expenses to Income Under Hubert,* 84 J. TAX'N 213 (1996); David Pratt, *Deducting Estate Administration Expenses: Does a Section 642(g) Election Still Make Sense?,* 65 TAX NOTES 1683, 1688 (1994); Jacques T. Schlenger, Robert E. Madden & Lisa H.R. Hayes, *Administration Expenses Payable from Income Do Not Reduce Marital and Charitable Deductions,* 23 EST. PLANNING 30 (1996); George L. Strobel II & Caroline D. Strobel, *The Proper Treatment of Administrative Expenses: The Debate Rages On,* 27 TAX ADVISER 228, 233 (1995). *Contra,* Student Note, *Tax Law: Administrative Expenses and the Charitable and Marital Deductions — The Potentially Painful Surprise of a 642(g) Deduction — Estate of Hubert v. Commissioner,* 20 U. DAYTON L. REV. 501 (1994).

reported by the Hubert Estate is precisely the same treatment the Commissioner would require had the Estate been able to promptly close into trust. Jeffrey N. Pennell, 843 TAX MGMT. ESTATE TAX MARITAL DEDUCTION at A-30 (BNA 1996). Applying Professor Pennell's test, if the Hubert Estate had been able to close immediately into trusts, the marital and charitable trusts would simply report income and expenses on the trust's fiduciary income tax returns, using the same forms and numbers used here. On these facts, the Estate could have no estate tax due, providing symmetry by fully accounting for the date-of-death corpus in distributions which qualified for the marital and charitable estate tax deductions. In turn, the true net income of the estate — the post-death income and administration expenses paid therefrom — would be reported by the trusts on the fiduciary income tax returns. That result cannot be changed without doing violence to the date-of death valuation regime merely because the estate administration is delayed.

Professor Pennell's analysis demonstrates that the Commissioner's position confuses the realities of estate administration with the date-of-death valuation rules. There is simply no justification for subjecting a delayed estate to different estate tax valuation treatment than one which is fortunate enough to close promptly.

6. Neither the Case Principally Relied Upon by the Commissioner in This Court, *United States v. Stapf*, nor Reg. § 20.2056(b)-4(b) Requires that Authorized Payments of Administration Expenses from Post-Mortem Income Reduce the Marital and Charitable Deductions Dollar-for-Dollar.

In addition to the three Fifth Circuit decisions in which the Commissioner successfully urged the Fifth Circuit to consider state law in determining whether the corpus bore the obligation to pay post-mortem administration expenses, the Commissioner

relies upon two authorities to create the disappearing residuary needed to produce a tax liability here. Both are unworthy of reliance.

a. The Commissioner Places Her Principal Reliance Upon a "Real Value" Argument Derived from *United States v. Stapf*, Which Does Not Relate to This Area of the Law.

For the first time in the eight-year history of this case, the Commissioner raises a "real value" argument derived from *United States v. Stapf*, 357 U.S. 118 (1963), and places her primary reliance on that argument. (CIR Br. *passim*.) According to the Commissioner, "real value" means that the date-of-death value of the property passing to either the widow or the charities can be valued only by reducing the value of corpus dollar-for-dollar by all post-mortem administration expenses paid out of post-mortem income.

Strangely, the Commissioner did not cite this case for this or any other proposition in her Petition for Writ of Certiorari. Nor was this case cited for this or any other proposition by the majority or the dissenting opinion in the Eleventh Circuit. And it was not cited for this or any other proposition by the majority or either of the two dissenting opinions in the Tax Court. The reason is that *Stapf* does not relate to this area of the law.[18] *Stapf*

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18. Although the Commissioner did not see fit to mention *Stapf* in her Petition for Writ of Certiorari, *Stapf* is now the authority upon which the Commissioner claims other courts of appeals relied in rejecting the Estate's position prior to the Eleventh Circuit's opinion below, including *Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied*, 510 U.S. 990, (1993); *Ballantine v. Tomlinson*, 293 F.2d 311 (5th Cir. 1961); and *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992). (CIR Br. at 20.) The Commissioner overstates the case. A quick review of the pre-*Estate of Hubert* cases reveals that: (a) the *Burke* court did not follow, cite or even mention

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is a *quid pro quo* case in which this Court recognized that the wife effectively purchased her interest from the estate by agreeing to transfer another interest she held to the children. It has nothing to do with post-mortem administration expenses or post-mortem income or their impact on date-of-death value. Moreover, the "real value" principle the Commissioner extracts from *Stapf* yields results that can only be described as startling.

Consider the arithmetic application of this "real value" position in the context of an example. Assume that John develops a computer modem that, on the day of his death, has a stipulated value of $5 million. His executor handles the administration of the estate in a reasonable manner but, on the eve of the expected closing of the estate, massive litigation is filed over the royalties generated by the modem. Years pass and $5 million of expenses are incurred before the litigation is resolved. Fortunately, the modem has been generating more than enough income to pay those expenses, and the Will and state probate law permit the payment of those post-mortem expenses out of this post-mortem income. The estate is then closed and the rights in the modem are, pursuant to John's Will, evenly divided between his widow and his favorite charity. At the time of the distribution, the modem rights now have a value of $10 million. According to the Commissioner, what is the date-of-death "real value" of those modem rights passing to the widow and the charity which were worth $5 million and are now worth $10 million? Zero.

To be precise, the Commissioner's *Stapf* position, coupled with her construction of the permissive example in her valuation

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Stapf; (b) the *Ballantine* court could not have relied upon *Stapf* since *Ballantine* predated *Stapf* by two years; and (c) *the Estate of Street* court cited *Stapf* only as a "*see, e.g.,*" cite, with no analysis whatsoever. Instead, the *Estate of Street* court placed its primary reliance on *Estate of Roney v. Commissioner*, 294 F.2d 774 (5th Cir. 1961), another decision which predates *Stapf*.

regulation, is that the "real value" is $5 million as of the date-of-death for estate tax inclusion purposes, but the "real value" of the same property on the same day is zero for distribution purposes because the value is somehow reduced dollar-for-dollar by any post-mortem expenses ever properly paid out of post-mortem income. Why? Because it allows the Commissioner to create a disappearing residuary and thereby collect over $2.5 million in taxes when none were intended by Congress.

The Commissioner presses this position by equating her fictional offset against the value of corpus with an actual reduction. She must resort to a federal fiction because the Commissioner admits that state law imposes no obligation on this corpus. Yet, fiction is not enough.

Throughout her brief, the Commissioner argues that discretion given to an executor by state law and in a Will to pay administration expenses from either corpus or income constitutes an "obligation" or "encumbrance" upon the date-of-death value of the property passing to the surviving spouse and to charity, without regard to the source of funds used to pay the administration expenses, and that § 2056(b)(4)(B) thus requires a reduction of the marital and charitable deductions. (CIR Br. at, *e.g.*, 16-19.) In attempting to force this issue into the *Stapf* mold, the Commissioner reads too much into both the statute and *Stapf*.

Just as in *Stapf*, § 2056(b)(4)(B) applies to instances in which the property of the decedent does not "pass" to the surviving spouse under the Will but instead is "purchased" by the surviving spouse. Thus, for example, if the spouse must retire a mortgage against property left to her in her husband's Will, that portion of the gross value of the property burdened by the mortgage does not "pass" to her under the Will, but instead she "pays" for it by retiring the mortgage. If the spouse must pay $5000 to the decedent's sister in order to take property under the Will, that property "costs" her $5000. Reg. § 20.2056(b)-4(b),

exs. 1 & 2. As well, § 2056(b)(4)(B) "obligations" or "encumbrance" exist as of the date of death. In contrast, when administration expenses are properly paid out of income, every dollar of corpus in the marital bequest which is in existence on the decedent's death actually passes to the surviving spouse. She incurs no "cost" in taking that date-of-death value, nor does she "pay" for it.

The Commissioner admits that administration expenses in the form of interest on estate taxes do not reduce the marital deduction. Like other administration expenses, this interest is unknown at the date of death and is thus not owed as of the date of death. It thus does not alter the date-of-death value of property passing to charity or to a surviving spouse when that interest expense is paid with estate income rather than corpus. Rev. Rul. 93-48, 1993-2 C.B. 270, *adopting the interest expense holdings in Estate of Street v. Commissioner,* 974 F.2d 723 (6th Cir. 1992), and *Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987).

This analysis for interest on estate taxes is a recognition of the role of §§ 2055(d) and 2056(b)(9), which preclude a charitable or marital deduction for amounts deducted under another section. Administration expenses, if and when deducted on an estate tax return and thus allocable to estate corpus, are deducted under § 2053(a)(2). When not deducted on the estate tax return and not paid from estate corpus, no diminution to the date-of-death value of property actually received by charity and the surviving spouse occurs. In short, the rule is simply that administration expenses deducted on the estate tax return necessarily reduce the value of the bequest which provides the corpus to pay those expenses and thus reduce the charitable or marital deduction. §§ 2055(a), 2056(a). When administration expenses are properly paid out of income and thus are not allocable to corpus, the full date-of-death value of that corpus is actually received by charity or the surviving spouse so that no diminution of the charitable or marital bequest may occur

without disregarding § 2055(a)'s and § 2056(a)'s directives that property actually received by charity and the surviving spouse pass free of estate tax.

Further, as the courts below held, § 2056(b)(4)(B) has no application to proper payment of administration fees from post-death income for two additional reasons: (a) under the Commissioner's estate and gift tax regulations and rulings expressly invoked by § 2056(b)(4)(B), the payment of trustee fees and administration expenses results in no diminution of corpus passing to the spouse; and (b) the Commissioner's new interpretation of a permissive example in Reg. § 20.2056(b)-4(a) is entitled to no deference from this Court. Mr. Hubert's Estate will address these in turn.

b. Under the Commissioner's Gift and Estate Tax Regulations and Rulings, Which are Expressly Invoked by § 2056(b)(4)(B), Payment of Administration Expenses Does Not Result in a Diminution of Corpus Passing to the Spouse.

The language of § 2056(b)(4)(B) requires that the effect of any encumbrance on value be determined as if a gift in trust to the spouse had been made. However, the Commissioner's argument characterizing payment of administration expenses from income as an "obligation" or "encumbrance" within the meaning of § 2056(b)(4)(B) ignores the very regulation written to speak to that issue. In fact, Reg. §20.2056(b)-5(f)(4) explicitly condones the power to determine the allocation of receipts and disbursements between income and corpus. That regulation addresses the marital deduction when, as is the case here, the surviving spouse receives a life estate with a general power of appointment.[19]

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19. Under the Second and Final Settlement Agreement, the Marital Share is divided between the GPA (general power of appointment) Trust and the QTIP Trust. Reg. §20.2056(b)-7(d)(2) incorporates these same principles with respect to the QTIP Trust.

The gift tax rule applicable in this situation, Reg. § 25.2523(e)-1(f), entitled *Right to Income,* interprets the requirement of § 2523(e) that a gift in trust to a spouse does not qualify for a gift-tax-free transfer to that spouse unless the donee spouse is "entitled for life to all of the income." In interpreting that requirement, the Commissioner's regulations make it clear that the requisite condition is met (Reg. § 25.2523(e)-1(f)(1)):

> if the effect of the trust is to give her substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of a trust. . . .

The regulation then parallels Reg. § 20.2056(b)-5(f)(4) by providing that the trustee's ability to allocate expenses as between income and corpus has no effect on the spouse's "beneficial enjoyment" if that choice is policed by the fiduciary obligations of the trustee to the spouse as income beneficiary (Reg. § 25.2523(e)-1(f)(4) (emphasis added)):

> (4) Provisions granting administrative powers to the trustee will not have the effect of disqualifying an interest transferred in trust [for want of entitlement to all of the income] unless the grant of powers evidences the intention to deprive the donee spouse of the beneficial enjoyment required by the statute. Such an intention will not be considered to exist if the entire terms of the instrument are such that the local courts will impose reasonable limitations upon the exercise of the powers. Among the powers which if subject to reasonable limitations

> will not disqualify the interest transferred in trust are *the power to determine the allocation or apportionment of receipts and disbursements between income and corpus.* . . .

The regulation notes that a spouse will be deemed to have received all of the income even if "trustee's commissions and other charges," all of which are administration expenses, are paid out of that income. Reg. § 25.2523(e)-1(f)(3). This, of course, is consistent with the proposition that an income beneficiary has no right to "gross income," but must pay his or her fair share of expenses.

Moreover, the Commissioner's estate tax regulations reach the identical conclusion when, as here, the surviving spouse receives a life estate with a general power of appointment. Those regulations provide that the surviving spouse "'is entitled for life to all of the income from the entire interest' . . . if the effect of the trust is to give her substantial . . . beneficial enjoyment. . . ." Reg. § 20.2056(b)-5(f)(1). The regulations then restate the exact language just quoted in the gift tax rules, concluding that if local courts impose reasonable limitations upon a trustee's exercise of fiduciary duties, the marital deduction will not be disqualified even though the trustee has "the power to determine the allocation or apportionment of receipts and disbursements between income and corpus. . . ." Reg. § 20.2056(b)-5(f)(4).[20]

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20. The year before Mr. Hubert died, the Georgia Supreme Court recognized such duties and limitations in a case involving the same trustee as in the Hubert Estate. *Citizens & Southern Nat'l Bank v. Haskins,* 254 Ga. 131, 327 S.E. 2d 192, 201 (1985) ("[w]hile there are rules for categorizing items as income or principal, the settlor may authorize the trustee to allocate interests to income which would otherwise be principal and vice versa. . . . When exercising this power the trustee must "act impartially as between income and principal beneficiaries").

Having thus set forth the fact that payment of administration expenses from income has no effect on the mandatory gift tax requirement that a spouse have a right to "all of the income," the Commissioner thereby has established that proper payment of administration expenses from income can have no effect on the net value of assets received by charity or the surviving spouse. Thus, the statute's requirement has been met that the "encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined." § 2056(b)(4)(B). In fact, the Commissioner has so ruled. In Rev. Rul. 69-56, 1969-1 C.B. 223, 224, the Commissioner wrote (emphasis added):[21]

> To charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses . . . *does not result in the* disallowance or *diminution of the marital deduction.*

This construction of § 2056(b)(4)(B) is the only one which

21. The Commissioner attempts to distinguish this ruling by arguing that the ruling addressed only whether "the inclusion of [discretionary powers to charge administration expenses to corpus or income] in the governing instrument" would result in the diminution of the marital deduction. The Commissioner then asserts that the ruling did not purport to address whether actual payment of administration expenses out of corpus or income would require a diminution of the marital deduction. (CIR Br. at 26 n.8.) This distinction is nonsense. The Commissioner is stating that she issued a hypothetical ruling which could never have effect — she states that she ruled that discretionary language in a Will produces no diminution of a marital deduction when the Will is written, but does so when the testator dies. This argument ignores the fact that a Will has no operative effect until death, nor is a marital deduction determined until death. In fact, the cited ruling is directly applicable to the valuation of property passing to the surviving spouse, because the valuation issue does not arise until death.

harmonizes the long-standing promulgations of the Commissioner in the form of regulations and rulings. In those pronouncements, the Commissioner has conceded that payment of expenses out of income does not constitute a "material limitation" on the spouse's right to the full value of the property, with the result that the full date-of-death value qualifies for the marital deduction. She has done so because no other conclusion is consistent with the statutory language.

c. The Commissioner's New Interpretation of a Permissive Example in a Valuation Regulation Is Entitled to No Deference from This Court.

In valuing the marital deduction, the Commissioner interprets a permissive example set forth in her regulations as setting forth an unbending rule, then asks this Court to apply the normal deference given to interpretive regulations to the Commissioner's incongruent interpretation, as opposed to giving deference to the text of the regulation itself. Reg. § 20.2056(b)-4(a). (CIR Br. at 27-29.) However, the only deference to which the regulation is entitled is for matters to which the regulation addresses itself.

The Tax Court majority correctly concluded that the allocation of post-death expenses to post-death income is a *valuation* matter under the regulation, as opposed to an obligation or encumbrance issue. (CIR Pet. at 40a.) The caption of the regulation, the first sentence, the example sentence and every other operative sentence speak to *value*. Moreover, this regulation is an interpretive regulation of a valuation statute, § 2056(b)(4), captioned "Valuation Of Interest Passing To Surviving Spouse."

There are many more reasons why the Tax Court declined to give deference to the Commissioner's mandatory interpretation of her valuation example. First, the example is stated in terms of

"may," which is classic permissive language. *Guilzon v. Commissioner,* 985 F.2d 819, 823 (5th Cir. 1993)); *Brimberry v. Commissioner,* 588 F.2d 975, 977 (5th Cir. 1979).[22]

Second, the example fails to state whether the executor was required by the Will or by state law to pay administration expenses with corpus. To the extent either is the case, of course, the value of the property passing to the spouse would be diminished. Indeed, the lack of any instruction in the example may well explain the use of the permissive "may," for if the executor were not so required, the fact of such a liability could not be known as of the date of death and there could be no diminution in that value.

Third, the "may" language is consistent with the fact that any permitted allocation of administration expenses between corpus and income post-death cannot be predicted without knowing what will occur during the process of administration. Since the allocation necessarily will be made with a fine eye to the adverse rights of the various parties, it is completely dependent upon events which are not known and not knowable at the date of death.

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22. Based upon various factual constructs, there was good reason for the Commissioner to phrase this example in permissive terms. In situations such as in *Alston, Estate of Roney* and *Ballantine*, the example is correct. Burdening the surviving spouse's right to income with expenses that are the legal obligation of the corpus-beneficiary is a material limitation. In other situations, such as in *Estate of Warren*, the permissive example would not apply because the post-mortem income is only burdened with its fair share of the post-mortem expenses and a surviving spouse only has a right to net income. Hence, there would be no limitation — material or otherwise — on the right to income. All manner of variations on materiality may exist between *Estate of Warren* on the one hand and *Alston, Estate of Roney* and *Ballantine* on the other. Indeed, the Commissioner has successfully urged that the effect of expenses paid out of post-death income varies with the facts. *Republic Nat'l Bank of Dallas, Trustee, v. Commissioner,* 334 F.2d 348,350 (5th Cir. 1964).

Fourth, before a testamentary provision may become a "limitation" under the regulation, before a "limitation" may become "material," and before the "effect" of any material limitation can be gauged, the spouse must have a "right to income." Without a "right to income," the regulation, by its own terms, has no application. "Right to income" implies an enforceable right. Nothing in federal, state, or common law bestows upon a spouse an enforceable, or even an equitable, "right to *gross* income." Yet, contrary to her regulations defining "Right to Income," that is precisely the import of the Commissioner's argument: any impingement on the future gross income of the spouse results in a dollar-for-dollar set off against the date-of-death value of the corpus. In other words, when an executor, trustee, or other fiduciary is faced with the question of how to allocate post-death expenses between corpus and post-death income, he or she — according to the Commissioner — is committing a *per se* violation of the income beneficiary's "right to income" if a penny of those administration expenses is borne by income. The corollary of the Commissioner's argument is that a fiduciary must thereby violate the rights of the corpus beneficiary in order to satisfy the alleged right of the spouse to *gross* income.

Finally, as the courts below recognized, the Sixth Circuit has applied the Commissioner's new interpretation of her 40-year-old regulation in an inconsistent manner. *Estate of Street v. Commissioner,* 974 F.2d 723, 729 (6th Cir. 1992), holds that one administration expense — interest on estate taxes — paid out of income does not decrease the marital deduction. 974 F.2d at 728, *citing Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987). As the Tax Court held, however, there is no rational distinction (CIR Pet. at 47a):

> In addition, administration expenses and interest on taxes cannot be distinguished according to the time at which they both

> accrue. Both accrue after the date of death. Administration expenses, by their very nature, are incurred over the entire period of the estate's administration and can vary significantly from estate to estate. As a result, administration expenses are too uncertain at the date of death to accrue at that time. Our analysis in *Estate of Richardson v. Commissioner,* 89 T.C. 1193 (1987), therefore applies to administration expenses as well as to interest on taxes, and we will follow our holding in that case.

Nevertheless, the Commissioner agrees with the *Estate of Street* court that interest on estate taxes does not reduce the marital deduction, but divorces that interest from other administration expenses. Rev. Rul. 93-48, 1993-2 C.B. 270.[23]

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23. Both the Sixth Circuit in *Estate of Street* and the Commissioner here rely on S. Rep. No. 1013, 80th Cong., 2d Sess. II-6, *reprinted in* 1948-1 C.B. 331, 335. However, that legislative history addresses claims, not administration expenses. Unlike administration expenses, all the events fixing a claim have occurred at the date of death, and the claim exists in a finite amount at that time. Further, the underlying assumption of the Committee Report is that the claims are necessarily a burden on the residuary corpus and therefore the payment of those expenses out of income decreases the residuary corpus passing to the spouse. In comparison, administration expenses are unknown at the date of death and may relate to either income or corpus. The cornerstone of *Estate of Street* and *Fisher v. United States*, 28 Fed. Cl. 88 (1993) (which merely follows *Street*), is the conclusion that the principal of the estate was unequivocally burdened with these administration expenses at the date of death. This simply was not true under applicable state law and the governing instruments.

As well, in *Burke v. United States,* the Federal Circuit conceded that state law governs the determination of property rights. Indeed, the controlling state law in *Burke* required the payment of expenses out of corpus and thereby

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For these reasons, the Commissioner's regulatory example is not black letter law. Her argumentative interpretation of her permissive example as mandating an unwavering rule is entitled to no deference whatsoever.

7. The Tax Court's Fact Findings Preclude an Examination of the Legal Issue Raised by the Commissioner.

The courts below properly rejected the Commissioner's unsupported thesis that as a matter of law, administration

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forced the same ultimate conclusion reached by the Federal Circuit in *Burke*. *Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied,* 510 U.S. 990 (1993). However, the *Burke* court framed the "pertinent question" as "whether payment of administration expenses must be accounted for in computing the value of a taxable estate under federal law for federal estate tax purposes regardless of the actual source of payment." 994 F.2d at 1580. This completely confuses the issue. Neither the marital share nor the charitable share are paid out of the "taxable estate." The relevant inquiry is not what is the taxable estate, but what is the residuary corpus payable to the marital share and the charitable share, which forms the marital and charitable deductions based on date-of-death values.

This misconception of the court in *Burke* leads to an asymmetrical result when expenses are properly charged to and paid from income and the executor elects to claim the administration expenses as an income tax deduction rather than as a deduction in reaching the taxable estate. As one respected commentator has noted:

> In confusing the amount actually passing to the charity and computation of the federal gross and then taxable estates, the court in *Burke* revealed that it had hardly a clue what was involved in the case. . . .

Jeffrey N. Pennell, 843 TAX MGMT. ESTATE TAX MARITAL DEDUCTION at A-30 (BNA 1996). The court of appeals here was more astute.

expenses reduce the marital and charitable deductions dollar-for-dollar, even when those expenses are paid out of estate income, as permitted by the Will and state law. (CIR Br. at 27-28.) However, the measuring concept of "value" is inherently a question of fact.[24] Thus, any effect of payment of administration expenses from income on the value of property passing to the surviving spouse and to charity is a question of fact. *Estate of Roney v. Commissioner,* 33 T.C. 801,804 (1960)("[a]s we see it, the problem [of the impact of administration expenses on the marital deduction] is essentially one of valuation— *i.e.,* what was the value of the property passing to the wife at the time of decedent's death"), *aff'd,* 294 F.2d 774 (5th Cir. 1961).

This dollar-for-dollar absolutism is inconsistent with the statute on which the Commissioner relies, § 2056(b)(4)(B). The marital deduction statute directs that "such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined." In interpreting this statute, for over 40 years, the regulations have provided "[i]n determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property. . . ." Reg. § 20.2056(b)-4(a). In "taking account" of any "material limitations upon her right to income from the property," no guidance is given other than the willing buyer-willing seller standard implicit in the concept of

24. Indeed, the Commissioner has consistently defined "value" as follows (Reg. §20.2031-1(b)):

> Value of property . . . is its fair market value at the time of the decedent's death. . . . The fair market value is the price at which the property would change hands between a willing buyer and a willing seller . . . both having reasonable knowledge of relevant facts. . . . All relevant facts and elements of value as of the applicable valuation date shall be considered in every case.

valuation. Thus, a trial court would be charged with determining, based upon proof presented at trial, (i) whether the contingent possibility that an unknowable amount of administration expenses could be paid from estate income constituted a "material limitation" upon her right to income from the property, (ii) if so, whether that material limitation reduced the value of the property passing to the spouse or to charity, and (iii) if so, the amount of the reduction in value. No proof on any of these factual issues was presented at this trial by the one party charged with the burden of proof — the Commissioner.

Further emphasizing the factual nature of the valuation inquiry, the gift tax rules referenced by the marital deduction statute identify even more valuation issues. For example, Reg. §25.2523(e)-1(f) provides that a spouse will be deemed to have received all income even if administration expenses are paid out of that income, provided the spouse is not deprived of the "substantial beneficial enjoyment" of the income. Thus, whether or not a deprivation of "substantial beneficial enjoyment" exists is a question of fact.[25] Once again, no factual evidence was presented on this issue by the Commissioner, who bore the burden of proof on this issue.

25. Other fact issues appear as well. For example, how can one identify without the assistance of a qualified appraiser the effect on corpus at today's fair market value of a chance of an indeterminable amount of expense which may be paid out of income five years hence? And what is the likelihood of that chance event taking place? Is that a limitation and, if so, is it material? If it is material, what is the effect? Finally, the statute, § 2056(b)(4)(B), directs that the encumbrance or obligation "shall be taken into account" as if a gift to a spouse were being valued. That phrase is used by Congress in estate tax valuation statutes and by the Commissioner in the underlying valuation regulations interchangeably with its plain meaning of "shall be taken into consideration," *i.e.*, it is purely a factual matter, requiring proof at trial. E.g., consider § 2031(b); Reg. § 20.2031-1(b); Reg. § 20.2031-2(f). In no event has "shall be taken into account" been considered to be a dollar-for-dollar limitation, as a matter of law, for a contingent obligation or encumbrance.

On questions of fact, the trial court's fact findings can be set aside only if clearly erroneous. § 7482(a)(1). In the decision in the court below, the Tax Court held (CIR Pet. at 41a):

> On the facts before us, we find that the trustee's discretion to pay administration expenses out of income is not a material limitation on the right to receive income. . . . [T]he income used to pay administration expenses is insubstantial compared to the lifetime of income Mrs. Hubert will receive from the property. Therefore, she is not deprived of substantial beneficial enjoyment, and she would be treated . . . as having received all of the income from the trust. If Mrs. Hubert is treated as having received all of the income from the trust, there can be no material limitation on her right to receive income.

The Commissioner has not appealed this fact-finding, nor can she, in light of her stipulations and her failure to introduce evidence to the contrary in accordance with her burden of proof. Thus, without regard to any academic interest in the legal question posed by the Commissioner, no factual predicate exists to merit the legal inquiry. *See* Jt. App. at 42-44. As a consequence, no decision reached by this Court can have any impact on the estate tax due by Mr. Hubert's estate.[26] U.S.

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26. The Commissioner's calculations to the contrary are: (a) contradicted by the binding Stipulations; and (b) outside the record. The Commissioner thereby attempts to do in this Court what her burden of proof required her to do in the Tax Court. (CIR Reply to Br. in Opp. to Pet. for Cert. at Addendum.) Not having had an opportunity to test that calculation via cross-examination, as would be possible if the Commissioner had even tried to carry her burden of proof in the Tax Court, the Estate can nevertheless point out

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CONST. art. III, § 2, cl. 2 (no advisory opinions); 28 U.S.C. § 2201 (no declaratory judgments in tax cases such as this one); 28 U.S.C. § 2111 (no reversal based upon harmless error); *Williams v. Zbaraz*, 448 U.S. 358, 367 (1980)(moot issues); *St. Pierre v. United States*, 319 U.S. 41 (1943).

CONCLUSION

The result reached in the reviewed decision of the Tax Court and affirmed by the Eleventh Circuit is factually, procedurally, and substantively correct. The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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AUGUST 1996

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obvious flaws in the calculation. First, it refers to the value of the gross estate from the tax return itself. However, as stipulated by the parties, the gross estate is $30,254,219, not $30,263,421. (Jt. App. at 39, ¶ 50.) As well, the Commissioner's stipulated marital deduction is $14,744,138 and her stipulated charitable deduction is $14,938,386, not the $12,525,143 and $12,042,434 numbers listed. See stipulations referenced at 7-9, *infra*. Based upon those stipulations, the unified credit completely shields this Estate from any estate tax liability, without regard to the other numbers contained in the Commissioner's calculation.

Supreme Court, U.S.
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No. 95-1402

In the Supreme Court of the United States

OCTOBER TERM, 1995

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ESTATE OF OTIS C. HUBERT, DECEASED,
C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In the Supreme Court of the United States

OCTOBER TERM, 1995

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER

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ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

Sections 2055 and 2056 of the Internal Revenue Code provide a marital and charitable deduction equal to the "value" at the date of death of property that passes to a surviving spouse or charity. When a marital or charitable bequest is burdened by the obligation of paying the expenses of administration of the estate, those costs—whether paid directly from the corpus or from the post-death income earned by the corpus of the bequest—must be subtracted from the gross value of the bequest in determining the "net value" or "real value of the gift" (*United States* v. *Stapf*, 375 U.S. 118, 125, 126 (1963)). As our opening brief describes in detail, the text and history of Sections 2055 and 2056, the contemporaneous regulations

of the Treasury Department and the decisions of this Court and of all but one of the courts of appeals require this same conclusion. See Pet. Br. 20-29; *Burke* v. *United States*, 994 F.2d 1576, 1581-1582 (Fed. Cir.), cert. denied, 114 S. Ct. 546 (1993); *Estate of Street* v. *Commissioner*, 974 F.2d 723, 726 (6th Cir. 1992); *Estate of Roney* v. *Commissioner*, 294 F.2d 774 (5th Cir. 1961), aff'g per curiam 33 T.C. 801 (1960).

None of the contrary arguments advanced by respondents withstands scrutiny. As the Fifth Circuit stated in *Alston* v. *United States*, 349 F.2d 87, 89 (1965):

> No amount of legalistic legerdemain can produce * * * "the principle that where expenses of administration are paid out of post-mortem income, the amount of corpus available for charity is not diminished by such payments * * * " as argued by the executors.

1. Respondents err in suggesting that the Commissioner's longstanding interpretation of Sections 2055 and 2056 yields "startling" (Resp. Br. 34) tax consequences. As the following example reveals, it is the position advanced by respondents that would produce irrational results.

Assume that a gross estate of $2,000,000 is left entirely to a surviving spouse, that the estate incurs and pays $500,000 in administration expenses and that the estate has income of $500,000 during the period of administration:[1]

> (I) If the estate pays the administration expenses out of the corpus of the bequest, it is

[1] For ease of exposition, these examples ignore the $600,000 unified credit provided by 26 U.S.C. 2010. If that credit were taken into account, it would complicate the discussion but not alter its substance.

undisputed (Pet. Br. 9; Resp. Br. 6, 18) that the estate has an administration expense deduction of $500,000 (under Section 2053(a)) and that the marital deduction is reduced by the amount of these administration expenses to $1,500,000 ($2,000,000 less $500,000). In this scenario, the estate has no *estate* tax liability because its total deductions still equal $2,000,000. The estate would be required, however, to pay *income* tax on its income of $500,000.

(II) If, however, the estate (as in the present case) pays the administration expenses out of its post-death income and elects under Section 642(g) of the Code to deduct those expenses on its *income* tax return rather than on its *estate* tax return, the analysis of the parties reaches different results.

> (i) Under the established view of the Commissioner, the election by the estate to take the deduction for administration expenses on its income tax return is effective to eliminate the *income* tax liability of the estate because the income of the estate and the deduction claimed under Section 642(g) are both $500,000 in this example. But the estate is then subject to the *estate* tax on a net estate of $500,000 because, as in example (I), the marital deduction must be reduced to $1,500,000 (due to the fact that the marital interest is burdened by the obligation to pay administration expenses) but, unlike in example (I), there is no administration expense deduction on the *estate* tax return because the estate elected to take that deduction on its income tax return. A taxable estate of $500,000 results in this example, but no income tax liability exists.

(ii) Under the construction of these provisions urged by respondents, however, the estate would escape *both* income and estate taxation for the entire bequest *and* for the post-death income of that bequest simply by electing to apply income, rather than corpus, to pay the administration expenses. In respondents' view, the marital deduction would be $2,000,000 (and would thus eliminate the estate tax) and the administration expense deduction elected under Section 642(g) on the estate's *income* tax return would eliminate its income tax liability.

For the reasons explained in detail in our opening brief (Pet. Br. 20-22), Congress did not enact these provisions to provide an elective tax shelter that would permit the estate to avoid all taxes on *both* corpus and income, as respondents implicitly contend. Instead, as the case law and the Commissioner's longstanding interpretation reflect, the estate either (i) may elect to take the administration expense deduction against the *estate* tax, leaving its post-death income subject to income tax, or (ii) may elect to take that deduction against its *income* tax, leaving that same portion of the estate subject to the estate tax. Section 642(g) provides an election for the application of this deduction, not a tax avoidance mechanism as respondents contend. See pages 17-18, *infra*.

2. Contrary to the contention of respondents and the amici, an obligation to pay administration expenses is not different in substance from an obligation to pay estate taxes or an obligation to pay any other burden or encumbrance imposed on a marital or charitable bequest. All such obligations reduce the "real value" or "net value" of the marital and charitable bequests in precisely the same manner.

a. Sections 2055 and 2056 expressly require that, when the burden of paying estate taxes is placed on the marital or charitable bequest, the marital or charitable deduction is to be "reduced by the amount of such taxes" (26 U.S.C. 2055(c); see 26 U.S.C. 2056(b)(4)(A)). This reduction is required without regard to whether these expenses are paid from estate corpus or estate income.

As explained in detail in our opening brief (Pet. Br. 20-22), Section 2056(b)(4)(B) articulates this same principle in a broader context. It provides that, when a marital bequest "is encumbered *in any manner*, or where the surviving spouse incurs *any obligation* imposed by the decedent with respect to the passing of such interest, such encumbrance or obligation shall be taken into account" in computing the amount of the marital deduction. 26 U.S.C. 2056(b)(4)(B) (emphasis added). As with estate taxes under Section 2056 (b)(4)(A), the encumbrances and obligations referred to in Section 2056(b)(4)(B) must be subtracted from the marital deduction without regard to whether they are paid from estate corpus or from estate income. As the legislative history of that provision explains, if the decedent bequeaths the residuary interest to the surviving spouse "and she pays, *or if estate income is used to pay*, claims against the estate so as to increase the residue, * * * the value of any such additional part of the residue passing to the surviving spouse can not be included in the amount of the marital deduction." S. Rep. No. 1013, 80th Cong., 2d Sess., Pt. 2, at 6 (1948) (emphasis added).

b. The broad language that Congress employed in Section 2056(b)(4)(B) is obviously comprehensive, rather than restrictive, in scope. The statute applies to "any manner" of encumbrance and "any obligation" imposed on a marital bequest. 26 U.S.C.

2056(b)(4)(B).[2] Administration expenses like estate taxes, mortgages and other burdens on a marital or charitable bequest—are an "encumbrance" or "obligation" within the scope of this statute because (i) the estate cannot be transferred to the beneficiary without incurring and paying those expenses and (ii) the burden of those expenses reduces the "real value" of the bequest (*United States* v. *Stapf*, 375 U.S. at 126).[3]

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[2] Congress did not limit the coverage of Section 2056(b)(4)(B) to mortgages, as the Florida Bar (Fl. Bar Amicus Br. 14) contends. While mortgages are listed in the legislative history as one example of an encumbrance or obligation placed on a bequest (S. Rep. No. 1013, *supra*, Pt. 2, at 6), an example of the application of a statute contained in its legislative history does not restrict the meaning of the statute (*United States* v. *National City Lines*, 337 U.S. 78, 81 (1949)):

> Obviously, an example is not a complete catalogue. The use of an example implies no purpose to restrict the meaning of the statutory phrase * * * precisely to the illustration selected.

[3] The basic principle of Section 2056(b)(4)(B)—that the marital deduction must be reduced by the amount of encumbrances that burden that bequest—is not limited to the marital deduction. In enacting this provision, Congress noted that the principles it embodies are "generally applicable in determining the net value of *any* gift or bequest." S. Rep. No. 1013, *supra*, Pt. 2, at 6 (emphasis added). The courts have thus consistently and correctly applied the marital and charitable provisions of the estate tax in *pari materia*, construing them in a consistent fashion. See, *e.g.*, *Burke* v. *United States*, 994 F.2d 1576 (Fed. Cir.), cert. denied, 510 U.S. 990 (1993) (charitable deduction); *Alston* v. *United States*, *supra* (charitable deduction); *Estate of Street* v. *Commissioner*, 974 F.2d 723 (6th Cir. 1992) (marital deduction); *Ballantine* v. *Tomlinson*, 293 F.2d 311 (5th Cir. 1961) (marital deduction). As one of the amici concedes, although Section 2055 does not contain an express provision corresponding to Section 2056(b)(4)(B), "from a conceptual standpoint the same limitations should apply" (Fl. Bar Amicus Br. 24).

As this Court explained in *Stapf*, "administration expenses" are like other claims against the estate because, with respect to both, the testator, "by directing that payment be made of debts chargeable to another or to non-estate property, *reduces his net estate and in effect confers a gift or bequest upon another.*" *Id.* at 134 (emphasis added).

As *Stapf* indicates, reducing the marital or charitable deduction by the amount of the burdens imposed on those bequests does not—as respondents suggest—cause a portion of the estate to "disappear" (Resp. Br. 13). When the obligation to pay administration expenses is imposed on the marital or charitable bequest, that "reduces [the] net estate" attributable to that bequest by "in effect" conferring that portion of the "bequest upon another" (375 U.S. at 134). Because that portion of the bequest has, "in effect," been allocated for the payment of administration expenses—rather than to the marital and charitable beneficiaries—the marital and charitable deductions are reduced commensurately. See *id.* at 125-126.

c. The fact that administration expenses are incurred after death does not distinguish them from other burdens that reduce the marital and charitable deductions. See Pet. Br. 24-25; *Ballantine* v. *Tomlinson*, 293 F.2d at 312-313.

Like administration expenses, estate taxes also do not come into existence and cannot be calculated until after death. But Congress expressly provided that the marital and charitable deductions are to be reduced by the amount of such taxes. 26 U.S.C. 2055(c), 2056(b)(4)(B). Moreover, respondents concede (Resp. Br. 6, 18) that, when administration expenses are paid from the corpus of the estate, the marital and

charitable deductions must be reduced by the amount of these expenses. Administration expenses paid from estate corpus are not different in nature from administration expenses paid from estate income—both come into existence after the decedent's death and both operate to reduce the value of the bequest and therefore to reduce the amount of the marital and charitable deductions.[4]

Respondents nonetheless object to this application of the statute for requiring what they describe as a "hindsight approach to valuation" (Resp. Br. 20). In *Harrison* v. *Northern Trust Co.*, 317 U.S. 476 (1943), however, the Court explained that Congress has expressly required such "hindsight" calculations to be made in valuing the marital and charitable deductions. As the Court stated in that case, the objection to the "fact that the tax may have to be computed by an algebraic formula or by complicated arithmetical methods * * * loses all significance when it is remembered that" the statute imposes this requirement. *Id.* at 481.

3. Respondents and the amici virtually ignore the decision of this Court in *United States* v. *Stapf*, 375 U.S. 118 (1963). Only one of the four amici even acknowledges its existence (Fl. Bar Amcius Br. 11) and, although respondents refer to this decision, they do so only in an effort to limit it to its facts. Respon-

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[4] In *Estate of Street* v. *Commissioner*, 974 F.2d 723 (6th Cir. 1992), the court of appeals concluded that, unlike administration expenses, payments of interest due on estate taxes do not reduce the marital deduction. Although courts have differed as to whether interest is a deductible administration expense (see *Estate of Whittle* v. *Commissioner*, 994 F.2d 379, 382-384 (7th Cir. 1993) (citing cases)), the Commissioner has acquiesced in the ruling in *Estate of Street* (Rev. Rul. 93-48, 1993-2 C.B. 270).

dents claim that *Stapf* is "a *quid pro quo* case" that applies only when the surving spouse is required to make a payment from her own funds as a condition of receiving the marital bequest (Resp. Br. 34). This attempt to narrow the holding of *Stapf* ignores the text of the decision and the text of the statute.

The statute involved in *Stapf*—Section 2056(b)(4)(B)—requires a reduction of the marital deduction when the marital interest is burdened by *any* encumbrance or obligation, not merely by a "quid pro quo." See pages 5-6, *supra*. The Court explained in *Stapf* that, under this statute, "[t]he appropriate reference" in determining the marital deduction "is not to the value of the gift moving from the deceased spouse but the net value of the gift received by the surviving spouse" (375 U.S. at 125). The Court stated that, when the marital bequest is burdened by the requirement that it be used to pay obligations of the estate, "the real value of the gift" is only "the net economic interest received by the surviving spouse" (*id.* at 126), which is the gross value of the gift reduced by the cost of satisfying the obligations imposed on the bequest. *Ibid.*[5]

Respondents' attempt to narrow *Stapf* to its facts is transparently an effort to avoid this clear holding of *Stapf*. For the reasons described in our opening brief (Pet. Br. 20-24), the holding in *Stapf* applies to, and governs, the present case.

4. Respondents and the amici misconstrue the meaning of the portion of Section 2056(b)(4)(B) that states that any "encumbrance or obligation" on the

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[5] Respondents suggest that the Commissioner has improperly "extract[ed]" a "'real value' principle * * * from *Stapf*" (Resp. Br. 34). But that principle did not have to be "extract[ed]" from *Stapf*—it was the express *ratio decidendi* of the holding in that case. 375 U.S. at 126.

marital bequest is to "be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined." 26 U.S.C. 2056(b)(4)(B). They erroneously contend that this statutory directive incorporates various gift and estate tax regulations and revenue rulings (Resp. Br. 37-41; Amer. Coll. Tr & Est. Amicus Br. 10-11; Coun. Ed. Amicus Br. 13-14).

The regulations and rulings that they cite, however, do not deal with the *amount* of the marital and charitable deductions, which is the issue addressed in this case. Instead, these regulations and rulings address the threshold question of the estate's *eligibility* for a marital deduction. A gift or bequest is *eligible* for the marital deduction only if the property involved is transferred to the spouse both in form and in substance. The Treasury Regulations list several conditions that must be met for the marital deduction to be available for a transfer in trust. One of these conditions is that the surviving or donee spouse must be entitled for life to all of the income from the entire interest. 26 C.F.R. 20-2056(b)-5(f), 25.2523(e)-1(a)(1). Certain powers vested in the trustee that may constrain the spouse's right to receive income, however, will nonetheless "not have the effect of disqualifying an interest transferred in trust" (26 C.F.R. 25.2523(e)- 1(f)(4)). One of those is "the power to determine the allocation or apportionment of receipts and disbursements between income and principal." *Ibid.*; see also 26 C.F.R. 20.2056(b)-5(f)(4). These regulations address only whether the mere existence of such a power in the trustee will "disqualif[y]" the transfer from the marital deduction. That is a far different question from the question presented in this case, which is the effect that the *exercise* of such a power may have on the *amount* of the marital deduction. These regulations do not purport to deal with

the latter question, as respondents and amici only indirectly acknowledge.[6]

The Revenue Ruling cited by respondents (Rev. Rul. 69-56, 1969-1 C.B. 23) is similarly inapposite. That Ruling describes various powers that may be granted to the trustee of a marital trust—including the power of the fiduciary to charge expenses of administration either to income or principal—and states that the "inclusion of such powers or directions in the governing instrument" and "the grant of such power in and of itself" will not result in the denial or diminution of the marital deduction. 1969-1 C.B. at 224, 225. This Ruling, like the regulations

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[6] Respondents briefly note that the regulations that they cite establish the requirements for "a gift in trust to a spouse [to] *qualify* for a gift-tax-free transfer" and list the permissible powers of the trustee that, even though they may interfere with the spouse's free enjoyment of the gift, will not cause the "marital deduction [to] be *disqualified*" (Resp. Br. 38, 39 (emphasis supplied)). The amici are equally indirect in describing these regulations. For example, while amici American Council on Education and United Way purport to rely extensively on "[t]he relevant gift tax regulations," they acknowledge that the regulations only state the rules that apply in determining whether "a trust will *qualify* for the marital deduction" (Amer. Coun. et al. Amicus Br. 13). The regulations cited by respondents and amici deal with "qualification," not with "valuation." This case, by contrast, concerns the proper "valuation" of an unquestionably "qualified" bequest.

Because these regulations do not deal with the valuation of the marital deduction, there is no merit to the contention of the amicus American College of Trust and Estate Counsel (Amer. Coll. Tr. & Est. Amicus Br. 10-12) that the Commissioner's position creates inconsistent tax treatment of estates governed by wills and those governed by revocable trusts.

that it interprets,[7] does not address the question of how the *exercise* of such powers may affect the proper valuation of a qualified marital deduction.[8]

The applicable "valuation" regulation is 26 C.F.R. 20.2056(b)-4(a), which was adopted contemporaneously with Section 2056(b)(4)(B) of the Code.[9] That regulation specifies that the amount of any encumbrance or obligation imposed on a marital bequest (including the burden of paying administration expenses) is to be subtracted from the gross value of that bequest in determining the marital deduction under Section 2056, just as it would be in valuing a gift for gift tax purposes (see Stephens, Maxfield, Lind & Calfee,

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[7] This Ruling interprets the regulations that describe the type of income interest that the spouse must receive for the transfer to *qualify* for a marital deduction. 26 C.F.R. 20.2056(b)-5(f)(1)-(4), 25.2523(e)-1(f)(4). Under these regulations, for the marital deduction to apply, the surviving spouse must have substantially that degree of beneficial enjoyment of the trust that would be afforded to a life beneficiary of a trust.

[8] The fallacy in respondents' invocation of the revenue ruling and regulations that relate to the *qualification* of the marital interest for the marital deduction is manifest. It would follow from their reading of these regulatory provisions that a reduction in the marital deduction would not be required even when administration expenses are paid from the corpus of the estate—a contention that no party has advanced and no court has accepted.

[9] Respondents acknowledge that this case turns on "valuation," for the ultimate issue is the proper "value" of the marital and charitable bequests (26 U.S.C. 2055(a), 2056(a)). Respondents err, however, in stating that "valuation" is a purely factual question (Resp. Br. 16, 46). The question presented is a legal one, not a factual one. It is whether, as the Commissioner submits, the "value" of the marital and charitable bequests is reduced by the burden imposed on those bequests to pay the expenses of admininstration of the estate.

Federal Estate and Gift Taxation ¶ 10.21[2][a] n.24 (6th ed. 1991), quoting S. Rep. No. 1013, *supra*, Pt. 2, at 6; *Laughinghouse* v. *Commissioner*, 80 T.C. 425, 430 (1983); *Drybrough* v. *United States*, 208 F. Supp. 279, 283 (W.D. Ky. 1962)). The regulation also makes it clear that this reduction is required whether the burden is satisfied through distributions of corpus or of "the income from the property" (26 C.F.R. 20.2056(b)-4(a)). The regulation thus implements the express understanding of Congress that, when the spouse pays directly, or "estate income is used to pay, claims against the estate," the marital deduction is reduced by the amount of such payments. S. Rep. No. 1013, *supra*, Pt. 2, at 6.[10]

Section 20.2056(b)-4(a) of the regulations broadly provides that any "material limitation" on the right of a spouse to receive income earned by the corpus of the marital bequest reduces the "value" of that bequest and therefore commensurately reduces the marital deduction. 26 C.F.R. 20.2056(B)-4(A). The burden of paying administration expenses constitutes a "material" limitation on the right of the surviving spouse to receive income within the meaning of this regulation, for it "reduces [the] net estate and in effect confers a gift or bequest upon another" (*United States* v. *Stapf*, 375 U.S. at 134). As the text of the regulation directly notes (*ibid.*):[11]

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[10] As Judge Dubina noted (Pet. App. 22a), and as the Fifth Circuit held in *Ballantine* v. *Tomlinson*, 293 F.2d at 313, the reference to "claims" in the legislative history is equally applicable to administration expenses. "The reason for including the one applies to the other." *Ibid.* See also *United States* v. *Stapf*, 375 U.S. at 134; pages 6-7, *supra*.

[11] The court of appeals noted that the administration expenses in this case were "over $2,000,000" (Pet. App. 3a). Although respondents suggest that some smaller amount was

> An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property * * * is to be used to pay expenses incurred in the administration of the estate.

5. Federal law, not state law, governs the resolution of this case. State law is relevant in determining the amount of allowable administration expenses and in determining whether such expenses are allocated to income or corpus. See Rev. Rul. 69-193, 1969-1 C.B. 222. As we explain in detail in our opening brief (Pet. Br. 31-33), however, federal law—not state law— determines the consequences that such expenses have in calculating the marital and charitable deductions on the federal estate tax return.[12]

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actually incurred (Resp. Br. 5 n.3), the record amply supports the court's calculation. The estate deducted administration expenses of $500,000 on the estate tax return and of $1,458,445 on the estate's income tax returns for the period between May 31, 1987, and May 31, 1990 alone (C.A. App. 53). See also C.A. App. 34-36, 42-43.

[12] Amici err in contending (Amer. Coun. Ed. Amicus Br. 9) that *Riggs* v. *Del Drago*, 317 U.S. 95 (1942), is to the contrary. That case did not involve the imposition of the federal estate tax. It involved the allocation—under the decedent's will and under state law—of the burden of that tax among the beneficiaries of the estate. *Harrison* v. *Northern Trust Co.*, 317 U.S. 476 (1943), which amici also cite, also involved the application of state law in determining the allocation of the estate tax "among the beneficiaries" (Amer. Coun. Educ. Amicus Br. 9). But that "state law" question has no relevance to this case. The administration expenses involved in this case were unquestionably allocated, under the will and under state law, to the marital and charitable bequests. The question that remains to be resolved—the proper construction of Sections 2055 and 2056 of the Internal Revenue Code—is purely a question of federal law.

There is no merit to respondents' contention that the Commissioner "dance[s] to a new tune" (Resp. Br. 29) in arguing that federal law controls this issue. The Commissioner's position in this litigation is far from new. For example, in the appellate brief filed by the government in 1961 in *Ballantine* v. *Tomlinson*, *supra*, the government argued that, "[u]nder federal law, a residuary bequest to a spouse must be reduced by the portion of administration expenses chargeable against it, regardless of the source from which they are actually paid" (Gov't C.A. Br. at 18 (No. 18,736)). Similarly, in 1965 in *Alston* v. *United States*, *supra*, the government argued alternatively (i) that the executors lacked power under state law to charge administration expenses to post-mortem income and (ii) that, if the executors had such power under Georgia law, federal law nonetheless required the charitable deduction to be reduced by the amount of administration expenses without regard to whether those expenses were paid from corpus or income.[13] The Commissioner took the same position in *Estate of Roney* v. *Commissioner*, 294 F.2d 774 (5th Cir. 1961).[14]

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[13] The brief filed by the United States in that case stated (Gov't C.A. Br. at 15 (No. 21,492)):

> [E]ven if, *arguendo*, the executors had the power under Georgia law to pay the administration expenses out of post-mortem income (which we deny), it nevertheless appears clear from reading Sections 2053, 2055 and 2056 of the 1954 Code * * * that the value of a gift of the residuum to a charity and the size of a charitable deduction which affects the statutory taxable estate should correspondingly also reflect a diminution of value of such residuum by the amount of the administration expenses * * *.

[14] In *Estate of Warren* v. *Commissioner*, 981 F.2d 776 (5th Cir. 1993), the government relied solely on the terms of the

Prior to the decision in the present case, the courts of appeals had consistently agreed with the Commissioner that, although state law determines whether administration expenses are to be paid from corpus or from the income attributable to the corpus, either type of payment reduces the "value" of the marital bequest and therefore reduces the marital deduction as a matter of federal law.[15] For example, in *Burke* v. *United States*, 994 F.2d at 1581, the court held that "[a]though [S]ection 2053 permits state law to determine what administrative expenses are 'allowable,' how section 2053 treats the allowable administrative expenses for estate tax deduction purposes is a federal question." See also *Estate of Street* v. *Commissioner*, 974 F.2d at 728; *Alston* v. *Commissioner*, 349 F.2d at 89 ("The effect of yielding to the executors' argument here would be to increase the amount of the gross estate by the amount of post-mortem income—a result directly contrary to the statutory definition of the gross estate."); *Estate of Roney* v. *Commissioner*, 33 T.C. at 803.

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will, which explicitly provided that all administration expenses were to be deducted from the corpus of the residuary estate. The government did not, as it customarily has done, alternatively address the ultimately controlling issue of federal law. See note 13, *supra*. That failure appears traceable to what (in retrospect) appears to have been a miscalculation of the strength of the government's position under the express terms of the will. It does not reflect any change in the Commissioner's longstanding view that, under federal law, any burdens on marital or charitable bequests reduce the value of those bequests (and therefore reduce the permissible marital and charitable deductions) without regard to whether the burden is paid from corpus or income.

[15] Commentators also have supported the Commissioner's consistent interpretation on this issue. See, *e.g.*, Gans, *Will Administration Expenses Charged to Income Reduce the Marital Deduction?*, 71 Journal of Taxation 90, 91 (August 1989); Brogan and Painter, *Administration Expenses May Lower Other Deductions*, 21 Estate Planning 131, 136, 137 (May/June 1994); Irwin, *Tax Law: Administrative Expenses and the Charitable and Marital Deduction—the Potentially Painful Surprise of a 642(g) Election—Estate of Hubert v. Commissioner*, 20 U. Dayton L. Rev. 501 (1994). See also Pet. App. 77a (Beghe, J., dissenting).

Respondents also cite various revenue rulings (Resp. Br. 29) in arguing that the Commissioner is now "danc[ing] to a new tune." These rulings, however, refer to state law only in determining the allowability of administration expenses, not in determining the federal tax consequences of allowable expenses. For example, in Rev. Rul. 66-21, 1966-1 C.B. 219, modified, Rev. Rul. 69-193, *supra*, the Treasury ruled that the deductibility of administration and funeral expenses of an estate subject to Texas community property laws depended on whether, under Texas law, all of the expenses, or only one-half, were chargeable to the decedent. Similarly, in Rev. Rul. 88-12, 1988-1 C.B. 330, and Rev. Rul. 78-419, 1978-2 C.B. 244, rendered obsolete by Rev. Rul. 88-12, *supra*, the Treasury ruled that whether administration expenses were to be paid from property passing to the surviving spouse or to other beneficiaries is to be determined under the will and state law. In the present case, by contrast, it is undisputed (i) that the administration expenses were allowable as a matter of state law and (ii) that the maritable and charitable bequests, and not any other beneficiary, were burdened by the obligation of paying those expenses. The revenue rulings cited by respondents thus simply have no relevance to this case.

6. The Florida Bar errs in contending (Fl. Bar Amicus Br. 3, 26-29) that the Commissioner's position will force all estates to account for administration expenses on their estate tax returns rather than on

their income tax returns, and will thereby make ineffective the election provided by Section 642(g) of the Internal Revenue Code. That statute, which was enacted in 1942, permits estates to deduct administration expenses on their income tax return (as expenses of producing income under 26 U.S.C. 212) *only* if they file a written waiver of their right to deduct such expenses on their estate tax return (as expenses of administration of the estate under 26 U.S.C. 2053(a)). 26 U.S.C. 642(g). The statute thus ensures that estates do not claim a deduction for these expenses on *both* returns. *Ibid.* See H.R. Rep. No. 2333, 77th Cong., 1st Sess. 75-76 (1942).

By thus prohibiting a double deduction of administration expenses, Congress did not ensure taxpayers that they would always benefit from the election that they make. Nothing in Section 642(g) seeks to alter the tax consequences of the deduction of such expenses under the substantive provisions of the estate tax and income tax. The statute is therefore not relevant to the proper interpretation of the substantive estate and income tax provisions involved in this case. See, *e.g.*, *Estate of Luehrmann* v. *Commissioner*, 287 F.2d 10, 12-13 (8th Cir. 1961); *Estate of Roney*, 33 T.C. at 804.[16]

Moreover, it is simply incorrect to suggest that, under the Commissioner's position in this case, estates would not be able to benefit from the election permitted by Section 642(g). The vast majority of estates—those that are not subject to the estate tax

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[16] The marital deduction did not even exist at the time Section 642(g) was enacted and there is no reference in the legislative history of Section 642(g) to the computation of the charitable deduction. S. Rep. No. 1631, 77th Cong., 2d Sess. 136 (1942); H.R. Conf. Rep. No. 2586, 77th Cong., 2d Sess. 52 (1942).

because of the $600,000 unified credit—will continue to benefit by deducting administration expenses on their income tax return. Without the election permitted by Section 642(g), these estates would obtain no benefit from administration expense deductions.[17] See J. Pennell, 239-4th *Tax Management Portfolio* (BNA) at A-22. Moreover, even when an estate is subject to tax, the estate will benefit from deducting administration expenses on its income tax return when the marginal tax bracket for income tax purposes exceeds the applicable bracket for estate tax purposes. These two types of estates are the dominant majority, not the exception.[18]

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[17] Other circumstances can also cause an estate not to be subject to the estate tax. For example, if the decedent leaves all his property to his surviving spouse or to charity, the estate will have no estate tax liability if it pays all administration expenses from corpus (Pet. Br. 9). Moreover, even if the estate pays administration expenses from income, it will incur no estate tax liability if the entire estate is bequeathed to the surviving spouse or charity and the administration expenses do not exceed the unified credit of $600,000.

[18] For reasons previously stated in detail (Pet. Reply Br. on Petition for Writ of Certiorari 5-6), there is no merit to respondents' suggestion (Resp. Br. 7-8, 48-49) that a decision on the legal issue presented in this case will have no effect on the estate's tax liability. The Commissioner has performed a tentative recalculation of the estate tax liability based on the assumption that the marital and charitable deductions are to be reduced by the administration expenses that had been deducted on the estate's income tax returns for the period prior to September 26, 1991 ($1,656,859). That calculation, which is based upon the parties' computations for the entry of decision in the Tax Court (Pet. App. 65a-73a), was submitted to the court of appeals and was attached as an appendix to the reply brief in support of the certiorari petition. Under this calculation, a reversal in this case would result in (i) elimination of the

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For the foregoing reasons and those stated in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

SEPTEMBER 1996

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overpayment of $344,438 determined by the Tax Court and (ii) an additional liability for the estate for an estate tax deficiency in excess of $154,000.

MOTION FILED
AUG 5 1996

No. 95-1402

(7)

In The

Supreme Court of the United States

October Term, 1995

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

ESTATE OF OTIS C. HUBERT, DECEASED,
C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,

Respondent.

On Writ Of Certiorari To The United States Court of Appeals For The Eleventh Circuit

MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL URGING AFFIRMATION AND BRIEF OF THE AMICUS CURIAE IN SUPPORT OF RESPONDENT

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MOTION FOR LEAVE TO FILE AMICUS CURIAE BRIEF OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL URGING AFFIRMATION

Pursuant to Rule 37.4 of the Rules of the Court, the American College of Trust and Estate Counsel moves to appear as Amicus Curiae and for leave to file the attached amicus curiae brief urging that the opinion of the Court of Appeals for the Eleventh Circuit be AFFIRMED. Pursuant to Rule 37.3, the Respondent has given the College a written consent to file this amicus curiae brief, but the Petitioner has not, thereby requiring that this motion be filed.

The College is a professional association of lawyers with a current membership of over 2,700 Fellows from throughout the United States who have been elected to membership by their peers on the basis of their professional reputation and their demonstrated exceptional skill and ability in probate, trust, estate planning and employee benefits law, and who have made substantial contributions to these fields through lecturing, writing, teaching, and bar activities. As a professional organization dedicated to the service and advancement of the law, the College wishes to make available to the Court its expertise in such a way as to provide whatever assistance it may in resolving the complex issues that have vexed the lower courts at all levels, and have produced significant uncertainty among practitioners and government personnel in the administration of estates throughout the country.

The College does not undertake the filing of amicus curiae briefs lightly. It has a stringent policy requiring that such briefs be filed on behalf of the College only on

issues of special significance to the legal profession and to the public, and then only with the consent of the Board of Regents of the College. Even then, such briefs may only be filed in support of a position of the College. Because of its recognized preeminence in the estate planning, probate, trust, and employee benefits bars, the College does not take a position without careful consideration, nor does it adopt a position that it believes is not in the public interest.

The issue to be decided in this case has a far-reaching impact both on planning for estate administration and on the administration itself. The members of the College each have many years of practical experience in planning and administering estates. This expertise provides a perspective not available from either the Commissioner or the individual taxpayer.

The College's brief supports the contention of Respondent that when administration expenses are properly charged to income under the applicable state law or the governing instrument, and are actually paid out of the income from the estate, the marital and charitable deductions should not be reduced. To hold otherwise is to thwart the intent of the laws of the several states that allow the estate to allocate payment of expenses between different beneficial interests. The College does, however, agree with Petitioner's statement that where administration expenses are properly charged to the corpus of the estate under applicable state law, the marital and charitable deductions must be reduced, even when estate income is used to pay the expenses.

The College's position differs to an extent from that of Respondent in that the College proposes a two-prong

test for determining whether administration expenses will reduce the marital and charitable deductions in a given estate. This test, not advocated by either Petitioner or Respondent, seeks to balance the interests of the estate and state law with the interests of the Commissioner.

The College's brief, while supporting the result urged by Respondent, nevertheless seeks to take a broader view of the problems and to deal with arguments that may not be sufficiently raised or dealt with by the parties. Additionally, the College will bring to the attention of the Court certain consequences, not readily apparent, which would naturally flow from a decision for Petitioner.

WHEREFORE, having shown that the College brings a different perspective to the proceedings, and that the expertise of the College in estate planning, probate, trust, and employee benefits law will allow it to bring to the attention of the Court relevant matters not raised by the

parties, the College prays that its motion for leave to file its amicus curiae brief be GRANTED.

Respectfully submitted,

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C & S SOVERAN TRUST COMPANY (GEORGIA) N.A.,
A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,

Respondent.

On Writ Of Certiorari To The United States Court of Appeals For The Eleventh Circuit

BRIEF OF THE AMICUS CURIAE IN SUPPORT OF RESPONDENT

QUESTION PRESENTED

Whether in calculating the taxable estate for the purpose of the federal estate tax, the marital and charitable deductions allowed by Section 2055 and 2056 of the Internal Revenue Code, 26 U.S.C. § 2055 and § 2056, are reduced by the expenses of administration of the estate that are properly chargeable to income under the applicable state law or the governing instrument.

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INTEREST OF THE AMICUS CURIAE

The College is a professional association of lawyers with a current membership of over 2,700 Fellows from throughout the United States who have been elected to membership by their peers on the basis of their professional reputation and their demonstrated exceptional skill and ability in probate, trust, estate planning and employee benefits law, and who have made substantial contributions to these fields through lecturing, writing, teaching, and bar activities. The College has no "client" in this matter, although many of its Fellows represent clients who will be impacted by the Court's decision, either now or in the future. But as a professional organization dedicated to the service and advancement of the law, the College wishes to make available to the Court its expertise in such a way as to provide whatever assistance it may in resolving the complex issues that have vexed the lower courts at all levels, and have produced significant uncertainty among practitioners and government personnel in the administration of estates throughout the country.

The issue to be decided in this case has a far-reaching impact on both planning for estate administration and on the administration itself. The members of the College each have many years of practical experience in planning and administering estates. This expertise provides a perspective not available from either the Commissioner or the individual taxpayer.

SUMMARY OF THE ARGUMENT

Administration expenses charged against income should not reduce a marital or charitable deduction, unless they are of such an amount that they constitute a material limitation on the deductible interest. While there always should be an offset for such expenses if they are charged to corpus, the Commissioner's own regulation requires an examination of whether payment of the expenses from income earned by the estate during its administration materially limits the entire income right of the spouse or charity. If the effect of the payment is considered material, that effect should be valued, and the amount so determined deducted from the value of the marital or charitable gift. If the limitation on the right to receive income is not material, the deductible amount of the gift should not be affected.

Such treatment does not create an abuse of the tax code, and neither the government nor the marital or charitable beneficiaries will be harmed. Furthermore, upholding the lower court decision will provide consistent treatment between transfers by will and those occurring through inter vivos trusts. The growing use of revocable trusts in estate planning makes this latter consideration especially pertinent.

Because there is no statutory authority for the position that some administration expenses are an encumbrance on the gross estate as of the date of death, while others accrue over the course of administering the estate, there is no basis in the tax law for creating different categories of administration expenses. This Court should not allow different treatment of some administration expenses based on distinctions that do not exist, and

therefore, the decision of the Court of Appeals should be upheld.

ARGUMENT

NEITHER THE FEDERAL ESTATE TAX STATUTE NOR THE COMMISSIONER'S OWN REGULATION REQUIRES THE MARITAL DEDUCTION TO BE REDUCED IF ADMINISTRATION EXPENSES ARE PROPERLY CHARGED TO ESTATE INCOME.

The principal issue to be determined in this case involves the construction of the applicable statutes and regulations. 26 U.S.C. § 2055 and § 2056 and 26 C.F.R. § 20.2056(b)-(4)(a), § 20.2056(b)-(5)(f)(3) and § 25.2523(e)-1(f)(3). Section 2056(a) provides a marital deduction in computing federal estate tax for the "amount equal to the value of any interest in property which passes . . . from the decedent to his surviving spouse." Similarly, section 2055(d) provides a charitable deduction in computing the estate tax equal to the "value of the . . . property" that is transferred to a qualifying charitable organization. The regulation most applicable to determining the amount of the deduction provides, in pertinent part, as follows:

> . . . The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, the same principles being applicable as if the amount of a gift to the spouse were being determined. In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to the

> income from the property. An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

26 C.F.R. § 20.2056(b)-(4)(a).

The Commissioner's interpretation of this regulation focuses on the "net economic interest" that is passed to the surviving spouse or charitable beneficiary. Unquestionably, when expenses are paid from the *corpus* of the estate (i.e., from the deductible gift), the net economic interest that is passed to the beneficiary is less, and the deduction should be reduced. If, however, there is sufficient estate income to pay those expenses and the *corpus* is kept intact, then the surviving spouse or charity will eventually receive not only the full bequest, but also will have a larger investment base that can generate more gross income, using the assumptions stated in the Appendix.[1]

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[1] To illustrate this principle, consider the following example. Assume one is offered the opportunity to purchase a 20-year bond with a $100,000 face, paying 10% annually. Further assume there is a $10,000 commission, but there are two possible ways it is charged: either pay the face value of $100,000 and receive no income the first year (the $10,000 of interest being used to pay the commission), or pay $100,000 and receive a bond with a face value of only $90,000 (the $10,000 commission reducing the principal of the bond), which would then pay interest the first year (and annually thereafter), but of only $9,000 per year. By reducing income in the first year to take advantage of the higher face value of the bond, and assuming all income is spent as it is distributed, the buyer's estate would be $10,000 greater at the end of 20 years ($100,000 face compared to $90,000), and the buyer also would have received about $10,000 more income over the term of the bond ($10,000 x 19 years as opposed to $9,000 x 20 years, ignoring income earned on the $10,000 used to pay the commission at the end of the first year).

Planners and the government alike agree that the marital deduction is "an important estate planning tool for married individuals by enabling them to defer federal wealth transfer taxes until the surviving spouse's death." Laura O. Lazarus, *Limitations on the Qualified Terminable Interest Property Marital Deduction: Estate of Ellingson v. Commissioner*, 46 Tax Law. 959 (Summer 1993). The purpose of deferring these taxes is to "protect the capital needed for the support and security of both spouses during their lives." Ronald D. Aucutt, *Further Observations on Transfer Tax Restructuring: A Practitioner's Perspective*, 42 Tax Law. 343 (Winter 1989). Reducing the marital deduction as urged by the Commissioner would, in turn, reduce the value of the estate passing to the surviving spouse, thus thwarting the purpose of the unlimited marital deduction that was adopted in 1981. The taxpayer is not *avoiding* estate taxes on the increased amount that passes to the surviving spouse; this amount (and perhaps more, based on a reasonable growth rate) will be collected from the spouse's estate at death. Thus, it becomes a *timing* issue as to when (not whether) these taxes are collected, and Congress has spoken to that issue, opting to permit deferral until the death of both spouses.

Under the stipulated facts of this case, the decedent died on June 2, 1986. A *bona fide* will contest followed,

which was settled on October 10, 1990. Substantial administration expenses were incurred in connection with that contest, numerous tax controversies and other aspects of the administration of the estate. During the relevant administration period, the estate (with assets of more than $30,000,000) generated income of more than $4,500,000 and incurred expenses of more than $2,000,000. Of this amount, approximately $507,000 was allocated to and paid from the principal of the estate, and the balance (presumably most of which were incurred after the estate tax return was filed) was allocated to and paid from post-death income of the estate. The expenses allocated to principal were deducted on the estate tax return, while those allocated to income were deducted on the estate's income tax returns.

The question presented is whether marital and charitable deductions allowed to the estate by sections 2056 and 2055 of the Internal Revenue Code are reduced by the expenses of administration of the estate allocated to and paid from the income of the estate. The Commissioner relies upon the language of regulation section 20.2056(b)-4(a) quoted above, acknowledging that this regulation section should be controlling. Accordingly, the most important issue before this Court is the correct interpretation of that regulation.

The Commissioner suggests that this regulation mandates subtractions from the value of the bequests otherwise qualifying for the marital or charitable deduction. She further contends that these subtractions are required in all cases in which administration expenses are allocated to income, without regard to the amount of the

estate income and the amount of the expenses paid therefrom. These contentions disregard the plain language of the regulation, and they are incorrect.

Instead, as noted by both the Tax Court and the Eleventh Circuit, the regulation addresses valuation. A correct analysis of its provisions involves a two-step process. First, there must be a determination of whether the payment of expenses from income constitutes a *material limitation* on the right of the surviving spouse or charity to receive income from the marital or charitable gift property. If such payments from income are not (in the Commissioner's regulatory words) a *material* limitation on the spouse's (or charity's) rights, then the regulation provides that the marital or charitable deductions are not affected, and the analysis is complete. In this regard, materiality must be measured under the facts and circumstances of the particular case. But if, under such circumstances, it is determined that those payments do constitute a material limitation, then (again in the words of the regulation) "account must be taken of the effect" of that limitation on the value of the property interest passing to the spouse or charity. In other words, if a limitation is material under the particular circumstances, then it must be valued, and the value so determined must be subtracted from the net value of the property interest to determine the deductible amount for purposes of the marital or charitable deduction.

In this case, the lower courts determined that there was no need to address the second step of this test. After carefully analyzing the facts in *Hubert*, the Tax Court determined that the payment of administration expenses out of income was not a material limitation on the right of

the surviving spouse or charity to receive income. In this connection, the Tax Court noted that, both under the statute and the Commissioner's interpretive regulations, the effect of an encumbrance on the spouse's interest should be determined with reference to the related gift tax marital deduction provisions. 26 U.S.C. § 2056(b)(4)(a); 26 C.F.R. § 20.2056(b)-(4)(a). Section 2523(e) of the Code and the regulations promulgated thereunder make it clear that a spouse is considered to receive all of the income from a trust, even if certain expenses and other charges (including fees and commissions paid trustees) are paid from trust income. 26 U.S.C. § 2523(e) and 26 C.F.R. § 25.2523(e)-1(f)(3). Similarly, in a Revenue Ruling that interpreted section 20.2056(b)-5(f)(3) of the estate tax regulations, the Commissioner has acknowledged that a discretionary power "to charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses" will cause neither the disallowance nor the reduction of the estate tax marital deduction. Rev. Rul. 69-56, 1969-1 C.B. 224.

The Commissioner's brief asks this Court to disregard the word "material" in the quoted regulatory language, suggesting that *any* allocation of administration expenses to the income of a marital or charitable bequest should result in a reduction in the value of that bequest for purposes of computing the applicable marital or charitable deduction. This approach ignores the plain language of the regulation, which states that any "material limitation" on the right to receive income be *given effect* in the determination of the value of the interest passing to the spouse for charity. The mention of administration

expenses in this section is identified as an *example* that "may be applied" where *all* of the income "from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate"; that language can not be construed as a mandate that the discretionary use of *some* income to pay such expenses is always a material limitation.

The Tax Court and the Eleventh Circuit both properly determined that there must be an initial analysis to determine whether the allocation of expenses to income results in a material limitation upon the spouse's or charity's right to income over the term of the gift. When the amounts charged to the income of a marital or charitable bequest – viewed in the perspective of the aggregate amount of income generated by that bequest – do not constitute a "material" limitation on the right of the surviving spouse or charity to receive income from the bequeathed property, no reduction of the marital or charitable deduction is called for by the regulation, and none is appropriate. Once the Court concludes that such payments are not material, that conclusion should be the end of the inquiry.

If, on the other hand, the payment of administration expenses from the income of a marital or charitable bequest *does* constitute a material limitation on the right of the surviving spouse (or of the charity) to receive income, then the issue becomes a question of valuation. In such circumstances, the value of the material limitation must be determined and the value so determined subtracted from the value of the qualifying property for

purposes of computing the applicable marital or charitable deduction. The Commissioner focuses too narrowly on a dollar-for-dollar adjustment to the marital deduction (suggesting that *any* adjustment is "material"), rather than analyzing the true economic impact on the marital gift by paying expenses from its income. The real economic value of a marital bequest in trust is not its immediate principal amount, but the income stream available for the surviving spouse's lifetime.[2] By reducing the marital deduction in an amount exactly equal to the portion of the income spent on expenses, the Commissioner is going beyond a concept of "giving effect" to material limitations on the income stream of the spouse or charity.

PERMITTING ADMINISTRATIVE EXPENSES TO BE CHARGED TO ESTATE INCOME WITHOUT AFFECTING THE MARITAL OR CHARITABLE DEDUCTIONS IS CONSISTENT WITH THE TAX TREATMENT ACCORDED A DECEDENT'S ASSETS THAT PASS UNDER A REVOCABLE TRUST.

A further flaw in the Commissioner's position is that it creates inconsistent tax treatment between estates governed by wills and those governed by revocable trusts. The Commissioner has attempted to focus the issue solely on her narrow reading of regulation section 20.2056(b)-(4)(a), but ignores that regulation's reference to other sections. In fact, the regulation states that the principles under the gift tax provisions will be applicable

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[2] See Appendix. The economic analysis in the Appendix is consistent with the Commissioner's other regulatory provisions that address substantially the same issue.

in making this determination of value. Under 26 U.S.C. § 2523(e), a deduction for a gift to a spouse in trust is permitted only if the spouse is entitled to all of the trust income. The regulations further provide that, so long as the spouse is not deprived of substantial beneficial enjoyment, he or she is considered to receive all of the trust income even when "trustees' commissions, and other charges" are paid out of the income. 26 C.F.R. § 25.2523(e)-1(f)(3). The estate tax regulations at section 20.2056(b)-(5)(f)(3) use the same language in the case of a gift by a decedent to a spouse made in trust so that, again, trustees' commissions do not affect the interest to be passed unless their payment constitutes a material limitation on the income interest. 26 C.F.R. § 20.2056(b)-(5)(f)(3). Indeed, the Commissioner has interpreted these sections in a published ruling and concluded that charging such administration expenses will not "result in the disallowance or diminution of the marital deduction under sections 2056 and 2523 of the Code." Rev. Rul. 69-56, 1969-1 C.B. 224.

To argue for a different result for probate estates creates a significant conflict between the tax treatment accorded the settlement of decedents' estates in which wills are involved and those in which revocable trusts are the principal testamentary device. The use of revocable trusts has increased significantly as a tool in estate planning over the past generation. To create such disparate treatment between probate and nonprobate gifts is illogical, lacks any policy basis, and creates an inconsistency in the application of the regulations.

It is, moreover, difficult to justify a distinction between trustee's commissions and other administration

expenses. Both are incurred while administering the transfer of an interest. The form of the transfer – by will or by trust – should not be the determining factor in deciding whether the marital deduction is to be reduced. Thus, to avoid a dichotomy between probate and trusts, administration expenses for a probate estate needs to be given the same effect as trustees' commissions and normally should not lead to a reduction in the marital deduction, unless their payment constitutes a material limitation on the spouse's income rights.

ADMINISTRATION EXPENSES CANNOT "ACCRUE" AT DEATH, AND THE COMMISSIONER'S POSITION TO THE CONTRARY IMPROPERLY CREATES DIFFERENT CATEGORIES OF ADMINISTRATIVE EXPENSES.

Although the principal focus of this case should be the two-part test discussed above regarding the existence of a material limitation on the right to income, the Commissioner argues for a *per se* rule that administration expenses – whether chargeable to corpus or to income – are an encumbrance on the gross estate that must reduce the marital and charitable deductions. This ignores the very significant legal differences in the rights accorded income and principal beneficiaries by the principal and income laws of the several states that direct how income and expenses of trusts and probate estates are to be allocated. Some jurisdictions have recognized that an inflexible rule that requires administration expenses be charged to corpus may be inappropriate, and have permitted discretion in the allocation of these expenses

between the assets of the estate and the income it generates after the decedent's death. *See e.g.*, Unif. Principal & Income Act (1962 Revised) § 5, 7B U.L.A. 160 (1996); Off. Code Ga. Ann. § 53-12-219 (1996); Tenn. Code Ann. § 35-6-113 (1996); 14 Vir. Stat. Ann. § 3304 (1995). Recognizing this distinction, the Commissioner has conceded that *certain* administration expenses properly chargeable to income do *not* reduce the marital and charitable deductions. Rev. Rul. 93-48, 1993-2 C.B. 270. Adopting her *per se* rule would force taxpayers to make illogical distinctions between various types of administration expenses.

In her brief, the Commissioner failed to address the Tax Court decision that began the inquiry into this issue, *Estate of Richardson v. Commissioner*, 89 T.C. 1193 (1987). That decision considered whether interest on estate taxes that accrues during the probate period is an expense that reduces the marital deduction. The court first held that interest on estate taxes is an administration expense rather than an additional tax. *Id.* at 1205. Because applicable state law allowed administration expenses to be allocated between principal and income, and because the estate rightfully chose to allocate and pay the interest on estate taxes from income, the *Richardson* court concluded that such an expense was deductible, and did not reduce the marital deduction. *Id.* at 1206. This holding has been cited with approval by *every* circuit court that has considered the issue: the Sixth Circuit in *Estate of Street v. Commissioner*, 974 F.2d 723 (6th Cir. 1992) and the Eleventh Circuit in this case. Additionally, the Commissioner has acknowledged the correctness of the Tax Court's recognition of the distinction between charging interest expense to income or principal, and has issued a Revenue

Ruling adopting the Tax Court's holding. Rev. Rul. 93-48, 1993-2 C.B. 270.

By making the argument that interest on federal estate taxes is different from other administration expenses, the Commissioner is asking this Court to create "categories" of administration expenses, some of which will reduce the marital and charitable deductions and some of which will not. Nothing in any version of the Internal Revenue Code supports such a result.

Despite this lack of statutory authority, the Sixth Circuit, in *Estate of Street*, somehow concluded that interest on estate taxes should be treated differently than other administration expenses. Perhaps it reached this erroneous result by focusing on prior situations in which administrative expenses were required to be charged under applicable state law to the corpus of the estate. Although the governing law in the Street estate permitted a proper charge of such expenses to income, the Sixth Circuit concluded that the estate tax result should be no different than if the expenses were required to be charged to corpus, because it considered that administration expenses "accrue at the time of death." *Estate of Street*, 974 F.2d at 727. Tellingly, the court cited no authority for this statement. Indeed, there is no authority for a position other than that administration expenses accrue as services are rendered to the estate, or an expense on its behalf is incurred.

The American College of Trust and Estate Counsel can find no legal or practical support for a position that administration expenses accrue at death, rather than during the administration of the estate. Unlike debts of a

decedent, the obligation to pay administration expenses arises when the service is rendered, or when the expense is incurred.[3] In cases such as this, where litigation is ongoing more than ten years after the death of the decedent, the costs of administration clearly have arisen over a period of time (much of which, as in this case, may be beyond the applicable estate tax statute of limitations). To argue that the Hubert estate had the obligation on June 2, 1986, to pay attorney's fees that would not be incurred until 1996 defies common sense and the probate and trust laws of the several states. Those laws, as modified by the applicable instrument, properly determine whether such expenses are to be charged against the principal of the residuary estate, or the income of the entire estate.

The Commissioner also argues that upholding the lower court ruling would allow the taxpayer the equivalent of a double deduction that is prohibited by 26 U.S.C. § 642(g). Section 642 prohibits an estate tax deduction for administration expenses that have been deducted against the estate's income tax. *Estate of Hubert v. Commissioner*, 63 F.3d 1083, 1085 (11th Cir. 1995). To allow such a deduction would lead to the estate deducting the same expense

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[3] The College recognizes that often administration expenses are deducted on a timely filed federal estate tax return before such expenses have actually accrued in a pure accounting sense; *e.g.*, attorney's fees and executor's commissions. The distinction drawn by the *Street* court and urged by the Commissioner as to the time of accrual of interest on taxes *vis-a-vis* other administrative expenses should not affect the ability of a taxpayer to make reasonable estimates of expenses for deduction on the federal estate tax return. The time of deductibility on the estate's income tax return is governed by the income tax rules.

twice. Yet there is no such prohibition or reduction under section 642(g) for marital or charitable deductions. *Id.* These deductions are based on the value of the gross estate at death, 26 C.F.R. § 20.2056(b)-(4)(a), not on how much administrative expense is incurred. In short, the *preservation* of the marital and charitable deductions is not barred by section 642(g).

CONCLUSION

The judgment of the Court of Appeals should be affirmed, and the two-prong test suggested in this brief adopted as a method of determining how administrative expenses, of whatever type, impact the amount of the marital or charitable deduction.

Respectfully submitted,

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APPENDIX

In our experience, the survivor generally spends all or a substantial part of the distributed income, and does not reinvest it. Assuming that to be the case, there will be a difference in cash flow to the survivor depending upon whether the income was used to pay expenses.[4] Therefore, to determine the real economic effect on the marital gift of treating income as the Commissioner suggests and to arrive at a fair conclusion regarding its true value, one should calculate the aggregate cash flow for the marital gift, both with and without the income used to pay expenses, and then reduce those respective amounts to present value. The only logical time-frame in which to make such a calculation is the life expectancy of the surviving spouse, which is easily determinable. For example, assume a residuary marital trust of $2,000,000 growing at a sustained rate of 4% per year and producing after-tax income at 6% per year. If the expenses of administration total $100,000, the surviving spouse can actually receive *more* gross income over his or her life by deducting expenses against income. Given a surviving spouse with a 15-year life expectancy, the stream of income available to the spouse after deducting administrative expenses would amount to $2,215,030. The value of the aggregate income produced for the same period by a lesser principal amount (reduced by $100,000 of the expenses as suggested by the Commissioner and also by

[4] If the assumption is changed and all income is reinvested at the same rate as the corpus, there should be no significant economic difference in the results, thus demonstrating again the lack of a material limitation on the income right.

the increase of $58,000 in estate taxes caused by the partial loss of the marital deduction) is $2,141,621. If the spouse in fact lives beyond 15 years, this discrepancy will accelerate, inasmuch as the principal of the marital trust is then $270,000 higher. Both computations assume the interest is expended and not reinvested. But even if the *present value* of this income stream is determined (which creates the need for more assumptions), any decrease in the value of the spouse's right to income is not material under these facts (the difference in present values being less than 5%).[5] Moreover, at no time is the combined value of the principal and distributed income *less* in the "payment of expenses from income" scenario.

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[5] The present value (calculated for 15 years at a 6% discount rate) of the stream of income earned when administration expenses are charged to income (column 3) is $1,343,837. The present value of the income stream when expenses are paid from and charged to the marital gift (column 6) is $1,371,928. The ratio of these present values is 97.95%.

	Administration Expenses paid from and charged against income			Administration Expenses paid from and charged against corpus of Marital Gift		
	Values during administration	Annual income earned	Cumulative Income	Values during administration	Annual income earned	Cumulative Income
Total Administration Expenses	100,000			100,000		
Income earned in first year (6% annual)	120,000			120,000		
Original Gift to Spouse	2,000,000			2,000,000		
Administration Expenses charged to principal	-0-			100,000		—
Net value of Marital Gift	2,000,000	20,000	20,000	1,842,000[6]	120,000	120,000
Values as of year 2[7]	2,080,000	120,000	140,000	1,915,680	110,520	230,520
Values as of year 3	2,163,200	124,800	264,800	1,992,307	114,941	345,461
Values as of year 4	2,249,728	129,792	394,592	2,071,999	119,538	464,999
Values as of year 5	2,339,717	134,984	529,576	2,154,879	124,320	589,319
Values as of year 6	2,433,306	140,383	669,959	2,241,074	129,293	718,612
Values as of year 7	2,530,638	145,998	815,957	2,330,717	134,464	853,076
Values as of year 8	2,631,864	151,838	967,795	2,423,946	139,843	992,919
Values as of year 9	2,737,139	157,912	1,125,707	2,520,904	145,437	1,138,356
Values as of year 10[8]	2,846,625	164,228	**1,289,935**	2,621,740	151,254	**1,289,610**
Values as of year 11	2,960,490	170,798	1,460,733	2,726,610	157,304	1,446,914
Values as of year 12	3,078,910	177,629	1,638,362	2,835,674	163,597	1,610,511
Values as of year 13	3,202,066	184,735	1,823,097	2,949,101	170,140	1,780,651
Values as of year 14	3,330,149	192,124	2,015,221	3,067,065	176,946	1,957,597
Values as of year 15	3,463,355	199,809	**2,215,030**	3,189,748	184,024	**2,141,621**

[6] Assuming the marital deduction is reduced, the loss of a deduction for administration expenses increases the estate tax by $58,000, which must be paid from the principal of the marital gift.

[7] Assuming appreciation of 4% per year for principal.

[8] This is the approximate breakeven point for income distributions. If a higher rate of return is assumed (e.g., the Applicable Federal Rate of 8.2% for June 1996), the breakeven point would occur earlier (between years 7 and 8).

No. 95-1402 (8)

Supreme Court, U.S.
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In The

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October Term, 1995

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

vs.

ESTATE OF OTIS C. HUBERT, DECEASED, C & S SOVERAN TRUST COMPANY (GEORGIA) N.A., A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF FOR AMICUS CURIAE THE TAX SECTION OF THE FLORIDA BAR IN SUPPORT OF RESPONDENT

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INTEREST OF AMICUS CURIAE

The Tax Section of The Florida Bar is filing this brief, as Amicus Curiae, in support of the position of the Respondent-Estate of O.C. Hubert and asks this Court to affirm the decisions below of the Eleventh Circuit Court of Appeals and the United States Tax Court.[1] Due to the large number of probate administrations opened in Florida each year this case will have great impact on Florida residents as well as professionals involved in the administration of estates and trusts. The case will also have an impact on charitable organizations who are dependent on private funding.

SUMMARY OF THE ARGUMENT

This case involves whether the marital and charitable deductions reported by the Respondent Estate should be reduced by the amount of administration expenses charged to income and deducted on the Estate's federal income tax returns. It is the position of the Amicus that no downward adjustment to either the marital or charitable deduction should occur since the economic interests of such beneficiaries were not adversely affected during the period of estate administration. The government's position is that the marital and charitable deductions should be automatically reduced or "set-off" by the amount of all expenses borne by the marital or charitable beneficiaries even though fiduciary accounting income exceeded expense by nearly $3.5 million over the first five years of administration.[2]

The government's position suffers from several defects. First, it effectively adds, without adequate support from the

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1. Counsel for both Petitioner, Commissioner of Internal Revenue, as well as Respondent, Estate of O.C. Hubert, consented to the filing of this brief as an Amicus Curiae. Rule 37.2(a), S. Ct. R. Prac. & Proc.

2. *See* discussion in note 35, *infra*.

relevant statutory provisions of the estate tax and its underlying legislative history, a second valuation date for federal estate tax purposes. The valuation date is generally the date of death and is used in valuing the gross estate. A second deemed valuation date is imputed by the government solely for the purpose of determining (reducing) the marital and charitable deduction. Such date may be characterized as the "charge-off" or "set-off" valuation date, *i.e.*, date of death value less allocable administration costs incurred during the the entire period of the estate administration.

Since post-mortem income allocable to marital and charitable beneficiaries is ignored by the Petitioner, the second valuation date can only result in a reduction of the applicable marital or charitable deduction. Therefore, where allocable administration expenses are deducted for federal income tax purposes instead of on the estate tax return, an increase in federal estate tax always results, even where the estate is to be distributed to a single marital or charitable beneficiary.

Based on the nature of an estate administration, the amount ultimately received by a beneficiary on date of distribution will rarely equal the finally determined estate tax value of the assets. This is because realized (as well as unrealized) income and expense during administration must be allocated among the estate's beneficiaries in conformity with state law. The Tax Court and Eleventh Circuit Court of Appeals recognized the fundamental distinction between date of death values used for federal estate tax purposes and values on dates of distribution used for probate purposes. The Tax Court referred to this as the difference between the amount of the "marital deduction", deductible under 26 U.S.C. § 2056, and the amount of the "marital share" or "marital portion", the amount ultimately received by the marital beneficiary after the estate administration is completed. The government's position, by failing to give substance to this distinction, contravenes the basic

structure of the prescribed method for computing the taxable estate.

A second defect in the government's position is that it ignores the language set forth in 26 U.S.C. § 2056(b)(4)(B) that the reduction in value of a marital bequest for an encumbrance or liability must be determined in accordance with gift tax valuation principles. For gift tax purposes, post-transfer expenses incurred by a donee do not reduce the value of the gift. Only where there is a "material limitation" on the right to receive the income from the property used to fund a marital or charitable bequest is a downward valuation adjustment required.

During the relevant period of the estate administration, fiduciary accounting income exceeded expense by nearly $3.5 million, which net income was allocated to the marital and charitable beneficiaries. A substantial portion of the administration expenses charged to income were incurred in operating and maintaining commercial real estate owned by the Estate. Rents generated from the properties paid such expenses. This resulted in a matching of income with expense for fiduciary accounting purposes. Furthermore, a substantial portion of the remaining administration expenses, *e.g.*, legal fees, court costs, etc., primarily benefitted the beneficiaries of the estate. Nevertheless, despite the matching of period revenues with costs, and resulting income and benefits derived by the beneficiaries, the government claims that the value of what each received for federal estate tax purposes should be reduced by administration expenses charged to income. In contradistinction, the only clear indication in the estate tax regulations of when a reduction from gross to net value should occur is where all income is necessarily charged for the payment of administration expenses. 26 C.F.R. § 20.2056(b)-4(a).

Third, Petitioner's argument effectively repeals 26 U.S.C. § 642(g), which permits an executor to deduct each item of

administration expense for federal income tax purposes instead of for federal estate tax purposes. Many estates, such as the one in this case, are planned in advance to avoid federal estate tax through use of the unlimited marital deduction and/or charitable deduction. In such instances, deducting administration expenses from the gross estate will have little, if any, benefit in reducing federal estate taxes. Tax benefit is received by deducting such expenses in computing the estate's taxable income. This is the purpose inherent in the 26 U.S.C. § 642(g) election. Yet, according to the Petitioner's reasoning, an executor's failure to claim what is otherwise a "wasted" estate tax deduction in order to reduce federal income taxes ironically triggers a greater estate tax cost than the income taxes saved. The government's argument turns the intended benefit of 26 U.S.C. § 642(g) upside-down.

Finally, the government's argument suffers from a conceptual weakness when it infers that had the administration expenses been deducted for federal estate tax purposes, no federal estate tax deficiency would have resulted. By increasing income taxes to save estate taxes, *i.e.*, by being forced to deduct administration expenses on the estate tax return, the same marital and charitable beneficiaries will also be charged with the payment of such expense. Through the Commissioner's own reasoning there will also be a reduction to net value for the increase in federal income taxes, which charge is non-deductible for both income and estate tax purposes. Based on the Petitioner's circular analysis, an estate tax will always be imposed even where the sole beneficiaries of an estate are a spouse and/or qualified charity as is present in this case. An absurd result such as this could not have been intended by Congress. Amicus contends that there is nothing in the statutory language, legislative history, or regulations to 26 U.S.C. § 2056(b)(4)(B) which support's the government's "automatic" or "set-off" reduction rule for administration expenses charged to income.

In an effort to aid this Court in evaluating this complex question, Amicus asks that this Court consider the following solution:

1. An administration expense claimed as a deduction for federal estate tax purposes which is borne by a marital or charitable beneficiary reduces the estate tax marital or charitable deduction by an equal amount. 26 U.S.C. § 2056(b)(4)(B);

2. An administration expense which, per 26 U.S.C. § 642(g), is deducted for federal income tax purposes and is borne by a marital or charitable beneficiary does not reduce the marital or charitable deduction for federal estate tax purposes unless the extent of all of such charges materially limits the right of the beneficiary to enjoy such property. Whether there is a material limitation must be determined by all facts and circumstances, including whether allocable income exceeded expense, the distribution of income during administration, whether the beneficiaries directly benefited from the subject expenses, etc.;[3] and

3. As to marital deduction trusts which impose a qualifying income interest requirement, no reduction to the marital deduction results merely by discretion granted to the executor or trustee to charge receipts and expenses between income and principal provided the exercise of such discretion is subject to court review.

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3. The courts have consistently held that where administration expenses are charged to principal under state law, a reduction in the "net value" of the amount passing to the marital beneficiary or to charity always results. *See Ballantine v. Tomlinson*, 293 F.2d 311 (5th Cir. 1961); *Estate of Roney v. Commissioner*, 294 F.2d 774 (1961), *aff'g per curium*, 33 T.C. 801 (1960). Although this result is correct where the recipient of income does not have the same identity of the recipient of principal, the result should be otherwise where such identity in interest is present, *e.g.* specific bequest of property or similar outright gift to spouse or to charity.

ARGUMENT

I. THE DECISION OF THE ELEVENTH CIRCUIT COURT OF APPEALS IS CONSISTENT WITH FUNDAMENTAL PRINCIPLES OF VALUATION USED FOR FEDERAL TRANSFER TAX PURPOSES

A. Basic Structure of Federal Estate Tax

The federal estate tax is imposed on a decedent's taxable estate based on the value of property and interests in property passing by reason of a decedent's death. 26 U.S.C. § 2051. The first step in determining the taxable estate is to compute the value of the gross estate. 26 U.S.C., Part III (§§ 2031-2046). The gross estate includes the value of all property comprising the decedent's probate estate, as well as property passing outside of probate with respect to which the decedent has retained certain rights or interests.[4]

From the value of the gross estate, deductions are allowed in arriving at the taxable estate. 26 U.S.C. Part IV, §§ 2052-2056A. Permitted deductions include claims against the estate, expenses of administration, and casualty-type losses unreimbursed by insurance or otherwise occurring during the estate administration. The value of property passing from the decedent to a surviving spouse or to a qualified public charity, is also deductible from the value of the gross estate. 26 U.S.C. §§ 2056 (marital deduction) and 2055 (charitable deduction).[5]

4. 26 U.S.C. § 2031.

5. Once the taxable estate is determined, the next step is to compute the tentative tax by adding the value of adjusted taxable gifts made during the decedent's lifetime to the taxable estate. 26 U.S.C. § 2001(b). The final computation is to reduce the tentative tax for gift tax paid and other credits in arriving at the estate tax amount. 26 U.S.C. §§ 2001(b); Part II, §§ 2010-2016.

B. Value of Gross Estate/Fair Market Value

For federal estate tax purposes, property is valued at its "fair market value" as of the applicable valuation date, *i.e.*, date of death. 26 U.S.C. § 2031.[6] Fair market value is the price derived from a hypothetical sale of the subject property between a willing seller and willing buyer, each having reasonable knowledge of all relevant facts and neither under any compulsion to sell or buy.[7] As the product of a hypothetical sale, fair market value is determined without regard to facts or occurrences concerning the particular estate, *i.e.*, identifying the specific property subject to probate, the projected or actual date of distribution or funding, etc.[8]

Accordingly, the fair market value of property for federal estate tax purposes is not reduced by charges or costs to which

6. 26 U.S.C. § 2031. 26 U.S.C. § 2032 permits the executor to elect to value the gross estate on the date which is six months after the date of death provided the aggregate value of the gross estate and sum of the estate and generation skipping transfer taxes imposed on the estate are both lower than the corresponding values and taxes computed as of the date of death. Even where alternate valuation is elected, only assets includible in the gross estate are subject to federal estate tax. 26 C.F.R. § 20.2032-1(d).

7. 26 C.F.R. § 20.2031-1(b).

8. The Tax Court in this case, as well as in a prior decision, rejected efforts by the Internal Revenue Service to discount to its present value the fair market value (at date of death) of property passing under a marital bequest for the intervening period of estate administration prior to the date of funding. *See Estate of Hubert*, 101 T.C. 314, 332-333, *Estate of Friedberg v. Commissioner*, T.C. Memo 1992-310. Ironically, Judge Halpern, who wrote one of the two dissenting opinions in the fully reviewed decision of the Tax Court in this case, issued the Memorandum Opinion in *Estate of Friedberg*. Amicus submits that the reasoning used by Judge Halpern in the earlier case appears to be at odds with his analysis in *Estate of Hubert*, especially in light of the economic facts in this case. *See* note 35, *infra*.

such property may later become subject.[9] Similarly, while fair market value takes into account the income producing potential of an asset on date of death, the right to receive income accrued and earned after the date of death is not includible in the gross estate.[10] This basic principle of estate tax valuation was

9. The Petitioner's view, as set forth it its brief, is to the contrary. Petitioner asserts that the value of an asset for federal estate tax purposes is like a "bundle of rights", with one of such "rights" consisting of the future income stream to be produced by such asset. Where income or corpus of a marital or charitable bequest is charged with the payment of estate expenses, Petitioner asserts that the value passing to the recipient, and therefore the marital or charitable deduction, is reduced. Petitioner's Brief, p. 16. Amicus contends that such position directly conflicts with the computation of fair market value for federal estate tax purposes. The Petitioner's "bundle of sticks" metaphor clearly suffers from a defect in consistency. By acknowledging that charges to the stream of post-mortem income "stick" reduces the value of the "bundle of rights", the government does not allow for an increase in value, for purposes of 26 U.S.C. §§ 2056 (marital deduction) or 2055 (charitable deduction) for post-mortem net income distributed to qualifying beneficiaries. In this case, post-mortem income less administration expenses (regardless of whether charged to principal or income) for the relevant five year period (1986-1991) was approximately $2 million. Petitioner's Brief, P. 8. Such income is distributable to the marital trusts and charitable beneficiary. Neither the Respondent has asserted nor does existing precedent allow for an increase in the marital or charitable deductions for allocable post-mortem net income and appreciation. The Petitioner's position can be characterized as a "heads I win, tails you lose" approach. On the one hand, if administration expenses are charged to income, estate taxes increase, regardless of whether post-mortem income fully absorbs such charges. On other hand, the marital or charitable deduction is not increased where allocable net probate income increases the actual or real value received.

10. *Alston v. Commissioner*, 349 F. 2d 87, 88 (5th Cir. 1965); *Waldrop v. United States*, 137 F. Supp. 753, 756 (Ct. Cl. 1956). *Compare Sharp v. Commissioner*, 19 F. 2d 802 (3rd Cir. 1937), *modifying* 30 BTA 532 (1934), *rev'd on another point*, 303 U.S. 624 (1938) (dividends on stock where record date after date of death not includible in gross estate); *Mandel v. Sturr*, 266 F.2d 321 (2nd Cir. 1959), *rev'g* (1957, D.C.N.Y.) 52 AFTR 1585(interest payable (Cont'd)

acknowledged by the holding of this Court. *Bull v. United States*, 295 U.S. 247, 55 S.Ct. 695, 79 L.Ed 1421 (1935).[11] The same valuation principles are used in establishing the value of a taxable gift.[12]

C. Estate Tax Marital Deduction

An estate tax marital deduction is allowed under 26 U.S.C. § 2056 for the value of any interest in property includible in the gross estate which either passes at death, or, has passed during the life of the decedent, to a surviving spouse.[13] Again, the value of property passing to a surviving spouse is its fair market value used in valuing the gross estate.

Where assets used to fund a marital deduction bequest either appreciate in value or are allocated income during the

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to estate on capital account of decedent's partnership interest accruing after date of death not includible in gross estate); Revenue Ruling 65-217, 1965-2 C.B. 214 (bonuses awarded to decedent after death not includible in gross estate) *with* 26 C.F.R. § 20.2031-3 (future earnings capacity relevant factor in valuing interest in closely held business); Revenue Ruling 68-609, 1968-2 C.B. 327 (valuation of stock in close corporation).

11. *Rev'g* 6 F. Supp. 141 (Ct. Cl. 1934)(post-mortem income from decedent's interest in partnership not includible in gross estate; allocable to income not corpus in accordance with state law). Only income accrued as of the date of death is includible in the gross estate. 26 U.S.C. § 691.

12. 26 U.S.C. §§ 2511, 2512. 26 C.F.R. §§ 25.2512-1, 25.2512-3. 26 U.S.C. § 2624. Special gift tax valuation rules under Chapter 14 of the Code, deviate from the general willing-seller, willing-buyer standard for gifts of certain retained interests in controlled entities or trusts. 26 U.S.C. §§ 2701-2702, 2704(a).

13. Donative transfers to a spouse during the decedent's lifetime qualify for the gift tax marital deduction. 26 U.S.C. § 2523.

administration period, no additional deduction results for the increased value passing to the marital beneficiary.[14] There also is no corresponding increase to the gross estate with respect to post-mortem income or appreciation. In similar fashion, no reduction to the marital deduction is made where the subject property declines in value between date of death and date of funding.[15] Unless the marital bequest takes the form of a (pre-residuary clause) pecuniary bequest, the value of property actually received by the marital beneficiary will always vary from the amount of the marital deduction.

There are several permitted methods of transfer which qualify for the estate tax marital deduction. Each method shares the same fundamental characteristic; the interest passing to a surviving spouse must be one which, when later transferred by the surviving spouse during his or her lifetime or at death, will result in gift or estate tax. 26 C.F.R. § 20.2056(a)-2(a). From an

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14. *Florida Bank at Lakeland v. United States*, 443 F.2d 467 (5th Cir. 1971). *See* Revenue Procedure 64-19, 1964 (Pt.1) C.B. 682. The Tax Court recognized as critical the distinction between the value of property ultimately received by a marital beneficiary (the "marital share" or "marital portion") from the value of property "passing to a surviving spouse" under 26 U.S.C. § 2056 (the "marital deduction"). The latter phrase does not reflect allocable appreciation and earnings during the period of administration. *Estate of Hubert v. Commissioner*, 101 T.C. 314, 315, fn. 1.

15. A fractional share marital deduction formula, *e.g.* percentage of residuary estate, requires that the marital beneficiary proportionately share in interim appreciation or depreciation through the date of distribution. *See* 26 C.F.R. § 20.2056(b)-5(a)(surviving spouse's interest reflects its proportionate share of the increase or decrease in the value of the entire property interest). Where the marital deduction is funded by a pecuniary bequest, however, appreciation or depreciation in asset values during the estate administration but prior to funding is borne by the non-marital beneficiaries. *But see* Revenue Procedure 64-19, *supra*, note 21 (guidelines restricting use of satisfying pecuniary bequests with estate tax values).

economic perspective, the estate tax marital deduction is simply a deferral in estate tax until a disposition is subsequently made by the surviving spouse.[16]

Two statutory rules reduce the marital deduction from the date of death value of assets used to fund the transfer. First,death taxes charged to property passing to a surviving spouse, 26 U.S.C. § 2056(b)(4)(A) reduce the marital deduction by such amount. This rule, which has a direct counterpart for the estate tax charitable deduction, 26 U.S.C. § 2055(c), ensures the

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16. *See United States v, Stapf*, 375 U.S. 118, 128 (1963). In the *Stapf* case, a wife elected to waive her one-half share in community property of her deceased husband's estate in order to benefit as a beneficiary under his will. The value of her right in the couple's community property she relinquished exceeded the value she received under the will. The effect of the waiver was a gift to the couple's children. In rejecting the estate's position that a marital deduction should be granted for the value of property received by the wife under the will, this Court held that the value of the assets passing to the wife must be reduced by the value of what she relinquished in the community property. Since the property bequeathed to the surviving spouse exceeded in value the property she relinquished, the widow received no "net benefit". Therefore, the marital deduction was denied. The holding in *Stapf* is presently embodied in 26 C.F.R. § 20.2056(b)-4(b), Example (3).

The *Stapf* case has frequently been cited by the Petitioner, Commissioner of the Internal Revenue Service, in direct support of its position in this case. Petitioner's Brief, passim. Amicus submits that the Petitioner's reliance on dictum from the *Stapf* case, is misplaced. This Court's decision in *Stapf* is not controlling of the issue before this Court since the *Stapf* case depends on the presence of community property as a predicate for its analysis. As such, were a court to have granted the taxpayer in *Stapf* a marital deduction, the rules applicable to the federal estate taxation of community property would have been subverted. This is because Mr. Stapf's gross estate only included one-half of the value of the community assets. Under the facts in the case, allowing any marital deduction would have, in effect, improperly granted a double deduction. *See* S. Rep. No. 1013, 80th Cong., 2d Sess. (1948), reprinted in 1948-1 C.B. 285, 304-305.

integrity of the marital deduction by imposing the death tax burden on non-marital assets.[17]

The second statutory rule, the proper application of which is in issue before this Court, is contained in 26 U.S.C. § 2056(b)(4)(B). This rule provides that where property passing to a surviving spouse is encumbered, only the "net value" of the property, *i.e.*, gross value less encumbrances, qualifies for the marital deduction. The method used in making this adjustment, as set forth in 26 U.S.C. § 2056(b)(4)(B), is that used for valuing a gift of encumbered property to a spouse for federal gift tax purposes.

> (B)where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to the passing of such interest, *such encumbrance or obligation shall be taken into account in the same manner as if the amount of a gift to such spouse of such interest were being determined.* [Emphasis added]

When 26 U.S.C. § 2056(b)(4)(B) was enacted in the Revenue Act of 1948,[18] the Board of Tax Appeals had held that a

17. Since the applicable charge for death tax reduces the marital deduction which in turn increases the tax, the computation is interrelated. *See* Revenue Ruling 77-345, 1977-2 C.B. 337. The same "tax-on-tax" effect is present under the government's position concerning charging administration expenses to income (or principal) of a marital or charitable beneficiary. Unlike encumbrances and liabilities described in 26 U.S.C. § 2056(b)(4)(B), death taxes, including federal estate taxes, are never deductible in computing the taxable estate. *See* 26 U.S.C. §§ 2011 (credit for state death taxes), 2012 (credit for gift tax), and 2013 (credit for prior transfers).

18. P.L. 471, 80th Cong., 2nd Sess., Ch. 168; § 361, 62 Stat. 177.

gift of mortgaged property must be reduced by the amount of the outstanding liability on date of transfer. *D.S. Jackman v. Commissioner,* 44 BTA 704 (1941), acq. 1942-1 C.B. 9.[19] Presumably, this is the "net value" result that Congress intended for the estate tax marital deduction.[20] Indeed, an example using mortgaged property was specifically recited in the Senate Report.[21]

Amicus views Congress' primary aim in enacting the net

19. Where the donor remains personally liable for repayment of the debt, the value of the gift may not be reduced by the mortgage. *See Commissioner v. Proctor*, 142 F.2d 824 (4th Cir. 1944), *cert. denied*, 323 U.S. 756 (1944). *See* Stephens, Maxfield, Lind & Calfee, *Federal Estate and Gift Taxation*, Warren, Gorham & Lamont, 6th Ed. (1991), p.10-42 to 10-43.

20. S. Rep. No. 1013, 80th Cong. 2d Sess. (1948), reprinted in 1948-1 C.B. 285. The legislative history reveals that Congress was aware of the holding in *Jackman, supra,* and the analysis set forth in the *Proctor* case by stating that the reduction for the mortgage amount applies with respect to a marital bequest of property subject to a mortgage regardless of whether the decedent was personally liable. Amicus is unaware of any subsequent reported gift tax decision after the Revenue Act of 1948 that is inconsistent with this principle.

21. *Ibid*, p. 335. "If the decedent by his will leaves to his surviving spouse real estate subject to a mortgage (whether or not such mortgage was a personal liability of the decedent), the value of the interest passing to the surviving spouse does not under this section include the mortgage. If, however, the decedent by his will directs the executor to pay off the mortgage, such payment constitutes an additional interest passing to the surviving spouse. If the decedent bequeaths certain property to his surviving spouse subject, however, to her agreement, or a charge on the property, for payment of $1,000 to X, the value of the bequest (and, accordingly, the value of the interest passing to the surviving spouse) is the value, reduced by $1,000 of such property."

value rule in 26 U.S.C. § 2056(b)(4)(B) was to prevent an estate from effectively claiming a double deduction for federal estate tax purposes. First, by deducting the liability as a claim against the decedent, per 26 U.S.C. § 2053, and then in claiming the gross estate value of the asset for marital deduction purposes. For example, suppose H dies owning Blackacre having a fair market value on date of death of $1,000x which is then subject to a mortgage of $500x. In his will H bequeaths Blackacre, subject to the mortgage, to W outright. Without 26 U.S.C. § 2056(b)(4)(B), H's estate would be permitted to claim a marital deduction of $1,000x even though it is also permitted a deduction of $500x under 26 U.S.C. § 2053. In order to prevent a double estate tax deduction, 26 U.S.C. § 2056(b)(4)(B) requires the marital deduction be reduced to reflect W's equity in Blackacre or $500x.

Insight as to the scope and application of 26 U.S.C. § 2056(b)(4)(B) is found in the legislative history of the provision, not only from what is recited, but by giving substance to what was left unstated. The only example used in the Senate Report to explain this provision was an outright bequest to a spouse of property subject to a mortgage.[22] The Senate Report instructs that under 26 U.S.C. § 2056(b)(4)(B), only the unpaid balance of the mortgage is reduced from the value of the property transferred. The Senate Report is silent on whether further reduction should result for post-transfer mortgage payments or expenses. For gift tax purposes no reduction occurs. Therefore, Amicus contends that such omission was purposeful and is consistent with the view that post-mortem charges for administration expenses charged to income do not automatically reduce the net value passing to a marital beneficiary.

Returning to the preceding example, assume that post-death property taxes of $50x and maintenance costs of $50x were paid

22. Note 21, *supra*.

by the executor prior to distribution of Blackacre to W. Based on the legislative history of 26 U.S.C. § 2056(b)(4)(B), there is no additional adjustment of $100x for the post-mortem payments. The same result would apply had Blackacre instead, for example, passed to W through an inter vivos trust after the expiration of H's retained interest for life in income,[23] or by reason of W's survivorship were Blackacre held as tenancy by the entireties.[24]

The Treasury issued regulations under 26 U.S.C. § 2056(b)(4)(B) in 1958.[25] In particular, 26 C.F.R. § 20.2056(b)-4(a) states, in relevant part:

> Marital deduction; valuation of interest passing to surviving spouse.—(a) In general. * * * The marital deduction may be taken only with respect to the net value of any deductible interest which has passed from the decedent to his surviving spouse, the same

23. A frequently used method for transferring property to a spouse is a revocable trust which is includible in the decedent-settlor's gross estate but not subject to probate. The surviving spouse's interest is not subject to estate tax under the (unlimited) estate tax marital deduction. The allocation of administration expenses under the (Revised) Uniform Principal and Income Act ("RUPIA") differs between estates and trusts. For estates, unless the will otherwise provides, administration expenses are charged to principal. RUPIA § 5(a). However, for trusts, including revocable trusts, many trust administration expenses are charged to income unless the trust otherwise provides. RUPIA § 13(a). Thus, for revocable marital deduction trusts, a trust must contain specific language ordering all administration expenses be charged to corpus to avoid the adverse result that the government seeks to impose in this case.

24. Although in this case, the inclusion of Blackacre in the gross estate may only have been for one-half of the gross value or $500x. *See* 26 U.S.C. § 2040(b).

25. T.D. 6296, 6/23/58.

> principles being applicable as if the amount of a gift were being determined. *In determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property.* An example of a case in which the rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate. [Emphasis added].

This regulation recognizes that the funding date of a marital bequest invariably will be postponed where assets used to fund such bequest are part of the probate estate. During the period of estate administration, income and expense will generally be allocable to marital property based on the decedent's will and applicable state law. The same economic adjustments for fiduciary accounting income are made with respect to marital deductions trusts which pass outside of probate. In Revenue Ruling 69-56, 1969-1 C.B. 224, the Service accepted that a trustee's right to charge income or principal for trust expenses was not a material limitation on a marital beneficiary's right to receive trust income and did not result in a disallowance or diminution of the marital deduction.

Liabilities of the decedent existing at death are deductible as claims under 26 U.S.C. § 2053.[26] Where marital property bears the economic burden of a claim, gross value is reduced to net

26. Unlike administration expenses which the executor may elect to deduct for federal income taxes instead of estate taxes, claims are only deductible for federal estate tax purposes.

value for marital deduction purposes.[27] This result, mandated by 26 U.S.C. § 2056(b)(4)(B), again forecloses a double deduction.[28] In a gift tax context, the outstanding claim would reduce the value of property transferred in the same manner.[29] The application of fiduciary accounting rules is consistent with this result as a claim will invariably be charged against principal since it is outstanding (choate or inchoate) at the moment of death (or gift).[30]

27. *See, e.g. Alexander v. United States*, 640 F.2d 1250 (Ct. Cl. 1981). The government previously attempted (only to later retreat) to stretch the application of 26 U.S.C. § 2056(b)(4)(B) to an illogical extreme with respect to contingent liabilities and the marital deduction. *Compare* PLR 9113009 (Dec. 21, 1990) *with* PLR 9409093 (Dec. 1, 1993). August, *IRS Reverses Prior Ruling on the Impact of Guarantees of the Marital Deduction*, 80 J. Tax'n 324 (June 1, 1994).

28. *Estate of Hubert v. Commissioner*, 101 T.C. 314, 323 (1993). *Estate of Street*, 974 F. 2d 723 (6th Cir. 1992), *aff'g in part*, T.C. Memo 1988-553; *Burke v. United States*, 994 F. 2d 1576 (Fed. Cir.), *cert. denied*, 114 S. Ct. 546 (1993), *Fisher v. United States*, 28 Fed. Cl. 88, 93 (1993).

29. A similar economic (and tax) result follows from a "net gift", *i.e.*, where the donee agrees in advance to pay the donor's gift tax liability on the property transferred. Revenue Ruling 75-72, 1975-1 C.B. 310; *Turner v. Commissioner*, 49 T.C. 356 (1968), non-acq. 1971-1 C.B. 3, *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969). *Cf. Diedrich v. Commissioner*, 457 U.S. 191, 102 S. Ct. 2414, 72 L. Ed. 2d 777 (1982).

30. RUPIA § 5(a). A decedent may direct by will however to charge claims to income. Administration expenses are charged to principal unless the will permits the executor to charge income. This provision was contained in Mr. Hubert's will. *Estate of Hubert v. Commissioner*, 101 T.C. 314, 316. Ga. Code Ann. §§ 53-2-101, 53-15-3. *Estate of Warren v. Commissioner*, 981 F.2d 776 (5th Cir. 1993) (allocation of administrative expenses did not reduce charitable deduction). The fiduciary must exercise the right to charge expenses and claims between income and principal in a "reasonable and equitable" manner. RUPIA 3(a)(3). Ga. Code Ann. § 53-12-212(a)(3). *In re Colyear's Estate*, 94 Cal. Rptr. 696, 17 C.A. 3d 173 (1971); *Jennings v. Speaker*, 571 P.2d 358, 1 Kan. App. 610 (1977); *In re Holloway's Will*, 323 N.Y.S. 2d 534 (1971).

The analysis by which claims of the decedent reduce the marital (and charitable) deduction is materially different than that used with regard to estate administration expenses.[31] As noted in this case by the Eleventh Circuit and Tax Court below, administration expenses evolve after the date of death, both as to liability and amount. The estate tax regulations note this fundamental distinction.[32] As further evidence of this fundamental difference, Congress allows executors the flexibility of deducting administration expenses from the gross estate, or, alternatively, from gross income in reducing taxable income for federal income tax purposes. 26 U.S.C. § 642(g).[33] The purpose of § 642(g) is to deny an estate both an income tax deduction and an estate tax deduction for the same economic

31. We note that several courts have refused to make this concession. *Estate of Burke v. United States*, 994 F. 2d 1576 (Fed. Cir.), *cert. denied*, 114 S. Ct. 546 (1993); *Fisher v. United States*, 28 Fed. Cl. 88, 93 (1993); *Estate of Street v. Commissioner, supra*, 974 F. 2d 723 (6th Cir. 1992), *aff'g in part*, T.C. Memo 1988-553.

32. *Compare* 26 C.F.R. § 20.2053-4 (amounts deducted as claims are "such only as represent personal obligations of the decedent existing at the time of his death, whether or not then matured, and interest thereon which had accrued at the time of death) with 26 C.F.R. §§ 20.2053-3(a)("administration expenses" . . . limited to those which are "actually and necessarily incurred in the administration of the decedent's estate"), 20.2053-1(a)(3)(vague or uncertain estimates of administration expenses not deductible until amount of liability is ascertained).

33. 26 U.S.C. § 642(g) only has applicability with respect to administration expenses or losses. It does not apply to either the marital or charitable deduction. Since marital transfers (other than alimony payments described in 26 U.S.C. §§ 71 and 215) are not deductible for federal income tax purposes while an estate (or trust) is not permitted a charitable deduction for income tax purposes for testamentary transfers to charity. Only amounts generated from subsequent receipts of post-mortem income or principal qualify for a charitable deduction for federal income tax purposes to an estate or trust. 26 U.S.C. § 642(c).

outlay. Unlike administration expenses, claims against an estate are outside of 26 U.S.C. § 642(g) and may only be deducted for federal estate tax purposes.

Under the facts in this case, the decedent's will granted the executor, as provided under applicable state (Georgia) law, the discretion of charging estate administration expenses "against income or principal or apportion the same".[34] During the applicable five year period, the estate received income of $5.44 million and incurred administration expenses of $2.5 million.[35]

34. *Estate of Hubert v. Commissioner*, 101 T.C. 314, 316. Ga. Ann. Code §§ 53-2-101, 53-15-3 (Michie 1982).

35. Amicus notes that the record is unclear as to the exact amount of income and expense incurred during the administration of the estate from the date of death, June 2, 1986, through September 26, 1991. The income tax returns reveal that for such period, aggregate gross income (reduced by capital gains of approximately $1.1 million which are generally allocable to corpus) was $4.14 million while aggregate administration expense was $1.14 million. Jt. Ex. 2-B, 3-C, 4-D and 5-E respectively. Net fiduciary accounting income was therefore $3 million. In addition, the federal estate tax return reported approximately $.5 million in deductions for administration expenses. This results in approximately $2.5 million of net income over total administration expenses during the first four years of administration. Judge Beghe's dissenting opinion in the Tax Court states that for the first five and one-half years of administration, *i.e.*, through September 26, 1991, income was "no less than $4.5 million" and total administration expenses were $2 million. 101 T.C. 314, 348. It is not clear how Judge Beghe arrived at his income calculation. Judge Beghe's expense calculation through September 26, 1991 apparently is based on expense information provided by the executor. Jt. Ex. 33A.G. The government's brief uses Judge Beghe's calculation. Pet. Brief, p.8.

Based on this discrepancy in information, Amicus projected one and one-third additional years of income (excluding capital gains) to the Estate for the period June 1, 1990 to May 31, 1991 based on the average of the preceding four years' income or $1.3 million. Thus, Amicus assumes that fiduciary

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The executor charged approximately one-fourth of such expenses or $.5 million to principal and claimed an estate tax deduction for such amount under 26 U.S.C. § 2053. The executor reduced the "net value" of the marital and charitable deduction by the same amount. The balance of the administration expense of $2 million were deducted for federal income tax purposes and charged to income. 26 U.S.C. §§ 642(g), 212. The Petitioner's position is that the value of the marital and charitable deductions must be reduced by the administration expenses charged to income which were deducted for federal income tax purposes.[36] This further results in an additional deficiency for the tax-on-tax effect since the same marital trusts and charity bear the burden of the estate tax assessment. 26 U.S.C. §§ 2056(b)(4)(A), 2055(c).

Where administration expenses are deducted for federal income tax purposes, generally the personal representative (or trustee of a trust includible in the gross estate) will charge the expense to income. This avoids a potential dispute among beneficiaries since to charge principal would unfairly benefit income, *i.e.*, the income beneficiary's federal income tax burden is reduced while the charge is economically borne by

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accounting income from June 2, 1986 through September 26, 1991 was $5.44 million while total administration expenses through September 26, 1991 were $2.5 million. Approximately $2 million of the administration expenses were charged to income and deducted on the estate's federal income tax return. The balance or approximately $.5 million, was charged to principal and deducted on the estate tax return. Jt. Ex. 1-A. Therefore, Amicus assumes that net fiduciary accounting income for the relevant five (and one-third) year period was approximately $3.44 million.

36. Furthermore, since the subject administration expenses before the Tax Court only covered the 1986-1991 period of administration, the total adjustment sought by the government would have to be increased by expenses charged to income from 1992 (to the present) and additional estate taxes computed on such amount.

principal.[37] Nevertheless, under the government's approach, even though income is properly charged for expenses used to reduce the income beneficiary's federal income tax liability, federal estate taxes are still increased by virtue of the foregone estate tax deduction. This cost will be charged to principal. Therefore, the government's position, if adopted by this Court, increases the potential for beneficiary conflict and fiduciary liability arising from the revised interdependent sequence and consequence resulting where administration expenses are charged to income.

D. Impact of Charging Administration Expenses to Income of Marital Deduction Trusts

The two marital deduction trusts involved in this case each separate the interest of the marital beneficiary, *i.e.*, income interest (to Mrs. Hubert) for life, from that of the remaindermen (children of the decedent). In an effort to qualify each trust for the marital deduction, the decedent's will, as revised by the settlement, designed one trust to qualify under in 26 U.S.C. § 2056(b)(5)(life estate, general power of appointment or "LE/PA" trust), and the other under 26 U.S.C. § 2056(b)(7) (qualified terminable interest trust or "QTIP" trust).[38]Therefore, Mrs.

37. In *Matter of Warms*, 140 N.Y.S. 2d 169 (Surr. Ct. NY Co 1955)(income beneficiary required to reimburse remaindermen for increased federal estate taxes as a result of estate's claiming income tax deductions for expenses charged to principal); *Estate of Bixby*, 140 Cal. App.2d 326, 295 P.2d 68 (1956). *See* Blattmachr, *The Tax Effects of Equitable Adjustments: An Internal Revenue Code Odyssey*, 18 U. Miami Inst. on Est. Plan., Ch. 14 (1984); Carrico & Bondurent, *Equitable Adjustments: A Survey and Analysis of Precedents and Practice*, 63 Tax Law 545 (1983).

38. The two important differences of a QTIP trust from a LE/PA trust are that QTIP is elective and the income beneficiary spouse does not have to possess a qualifying general power of appointment over the trust's assets (or

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Hubert had to receive, inter alia, a qualifying income interest for life, *i.e.*, right to receive all income of each trust in annual or more frequent intervals for her lifetime. 26 U.S.C. §§ 2056(b)(5), 2056(b)(7)(B)(ii)(I). Accordingly, in addition to the "net value" concept of 26 U.S.C. § 2056(b)(4)(B), consideration must be given to whether there is a disqualification or diminution in the amount of the marital deduction where income of a LE/PA or QTIP trust is charged with payment of administration expenses.

The regulations to the qualified income interest of a LE/PA trust, which also apply to QTIP trusts, requires that the terms of the trust instrument, as well as applicable law, provide the surviving spouse with "substantially that degree of beneficial enjoyment of the trust property during her life which the principles of the law of trusts accord to a person who is unqualifiedly designated as the life beneficiary of the trust".[39] In other words, neither the trustee nor any third party may accumulate income or distribute income to a person other than the surviving spouse.[40]

The estate tax regulations specifically acknowledge the necessary application of state law in determining whether the qualifying income interest rule is met. In this regard, 26 U.S.C. § 20.2056(b)-5(f)(1) provides that the spouse of a marital deduction trust receives the requisite income interest as long as he or she receives "substantially that degree of beneficial

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qualifying portion thereof) during her lifetime and/or at death. Each type of trust overrides the normal rule which prohibits terminable interests, *e.g.* life estates, from qualifying for the marital deduction.

39. 26 C.F.R. §§ 20.2056(b)-5(f)(1), 20.2056(b)-7(d)(2). *See* Revenue Ruling 69-56, 1969- 1 C.B. 224; Revenue Ruling 85-35, 1985-1 C.B. 328.

40. 26 C.F.R. §§ 20.2056(b)-5(f)(4), -5(f)(5).

enjoyment...which the principles of the law of trusts . . . accord the life beneficiary". 26 C.F.R. § 25.2523(e)-1(f)(1)(same provision for gift tax purposes). The estate tax regulations, as well as corresponding provisions of the gift tax regulations, acknowledge that a trustee's discretionary powers to allocate receipts and expenses between income and principal will not adversely affect the qualification of a LE/PA or QTIP trust as long as the exercise of such powers is subject to reasonable limitations under local law.[41]

More specifically, 26 C.F.R. § 20.2056(b)-5(f)(9) states, in relevant part:

> An interest is not to be regarded as failing to satisfy the conditions . . . (that the spouse be entitled to all the income and that it be payable annually or more frequently) merely because the spouse is not entitled to the income from estate assets for the period before distribution of those assets by the executor, unless the executor is, by the decedent's will, authorized or directed to delay distribution beyond the period reasonably required for administration of the decedent's estate. As to the valuation of the property passing to the spouse in trust where the right to income is expressly postponed, see §20.2056(b)-4.

Under the facts of this case, the income beneficiary of the marital deduction trusts received distributions of income of approximately $2 million during the first five years of the

41. 26 C.F.R. §§ 20.2056(b)-5(f)(2), -5(f)(4) (estate tax), 25.2523(e)-1(f)(2) to -1(f)(4) (gift tax). *See* Revenue Ruling 69-56, 1969-1 C.B. 224.

administration.[42]There was also an additional $1.44 million in fiduciary accounting income realized by the estate during the same period which is allocable to the residuary estate, *i.e.*, the marital and charitable beneficiary. The marital beneficiary further directly benefitted from a substantial portion of the administration expenses which were incurred in connection with probate litigation affecting her interest in the estate. As such, the record does not reflect either a material limitation on the income beneficiary's enjoyment of income from the marital trusts or other impediment to satisfying the qualified income interest requirements.

E. Charitable Deduction

The value of property passing to qualified public charity is deductible for federal estate (and gift) tax purposes. 26 U.S.C. §§ 2055(estate), 2522(gift). As with 26 U.S.C. § 2056(b)(4)(A) pertaining to the marital deduction, 26 U.S.C. § 2055(c) provides that any estate or inheritance taxes borne by the charitable beneficiary reduces the value of the deduction. Although neither 26 U.S.C. § 2055 nor 26 U.S.C. § 2522 contains a provision corresponding with 26 U.S.C. § 2056(b)(4)(B), from a conceptual standpoint the same limitations should apply. Therefore, any claim or liability to which the property transferred to charity is subject on the date of the decedent's death should result in a corresponding reduction in the charitable deduction. Existing precedent also confirms that administration expenses charged to principal reduce the charitable deduction, even if such expenses are deducted for federal income tax purposes. Any further attempt, however, to analogize this area to the marital deduction, and, in particular marital deduction trusts, rests on a less stable foundation, due to the lack of symmetry

42. Jt. App., p. 51.

between marital deduction trusts and gifts to charity.[43]

The record in this case reveals that during the first four years of administration income amounts set aside to the charitable beneficiary were claimed as deductions on the returns of approximately $1.67 million. 26 U.S.C. § 642(c). Based upon information provided by Counsel for Respondent, the 1991 set aside amount to the charitable beneficiary was approximately $.264 million, resulting in a total of $1.934 million. Such set aside amounts, which will ultimately be distributed to the charity, were used to produce a 52% (to Mrs. Hubert) and a 48% (to the charity) allocation of fiduciary net income allocable to the residuary beneficiaries based on the settlement. Amicus submits that the record does not reveal any material limitation on the charitable beneficiary's right to income during the estate administration. Therefore no reduction to the charitable deduction should result for administration expenses charged to income.

II. THE PETITIONER'S POSITION IS IN DIRECT CONFLICT WITH CONGRESS' INTENT IN PERMITTING ESTATES TO CLAIM ADMINISTRATION EXPENSES EITHER FOR FEDERAL INCOME OR FEDERAL ESTATE TAX PURPOSES

The net effect of the government's position is to impose a

43. In this case, the gift to charity is outright and free of trust. Were the interest to be that of a future interest, *i.e.*, qualifying split-interest charitable remainder trust, a similar issue as to the estate tax impact in allowing the personal representative to charge expenses between income and principal would arise. By further analogy to marital deduction trusts, including the qualifying income interest rule for LE/PA and QTIP trusts, a charitable remainder benefiary's economic interest would be enhanced by charging administration expenses to income (non-charitable beneficiary). On the other hand, if the charity had a "lead interest" for a stated term, charges to income would reduce the charity's flow of funds.

federal estate tax on administration expenses in the amount of approximately $2 million. Such expenses were charged against income by the executor in a manner consistent with the decedent's will and state law. It was of tax benefit for the executor to elect to deduct such expenses on the estate's federal income tax return instead of on the estate tax return since to claim the deduction on the latter return would be of no tax benefit, *i.e.*, a wasted deduction.[44]

The Petitioner's view is that by charging administrative expenses to income, in order to claim a tax benefit for federal income tax purposes, the "net value" of property passing from the estate to the marital and charitable beneficiaries is reduced on a dollar-for-dollar basis. This valuation reduction increases federal estate tax, the payment of which is also directly borne by the same marital and charitable beneficiaries. 26 U.S.C. §§ 2056(b)(4)(A), 2055(c). After factoring in additional "tax-on-tax", plus statutory interest, the resulting deficiency in estate tax will exceed the total amount of administration expenditures charged to income.

Congress, in 1942, enacted 26 U.S.C. § 642(g) (formerly § 162(e)(1939 Code)) to prevent taxpayers from deducting investment type expenses for both income tax and estate tax purposes.[45] Congress left it up to the executor whether to claim

44. As originally reported by the Estate on its Federal estate tax form 706, the gross estate was valued at approximately $30 million while approximately $27 million was claimed as qualifying for either the marital or charitable deduction. The reported taxable estate (plus adjusted taxable gifts) was $1.5 million and the estate tax was assessed by the Estate to be $345,000 or slightly more than 1% of the gross estate. Therefore, the Estate, as reflected on the federal estate tax return, was essentially non-taxable for federal estate tax purposes.

45. The section was enacted at the same time that Congress granted individuals, estates, and trusts, the right to claim income tax deductions for (Cont'd)

each item of eligible deduction on either the estate or income tax return. Since executors are generally held accountable to the standard of attempting to lawfully minimize federal taxes, where there is otherwise little, if any, federal estate liability, as is the case here, deductions will be claimed for federal income tax purposes. In this case, the $2 million in claimed income tax deductions for administration expenses have the potential to reduce federal income taxes to the estate (or beneficiaries receiving distributions during the estate administration) by as much as $.8 million.[46]

The effect of the government's position is that in order to save $.8 million in federal income tax in accordance with 26 U.S.C. § 642(g), the Respondent estate must incur additional estate taxes approaching $2 million. This obviously is an illogical election for the executor to make and would easily subject it to liability yet this is exactly what the executor, a large trust company, in this case elected. Conversely, in order to save the additional estate taxes of $2 million, the government requires that all administration expenses be deducted on the estate tax return thereby increasing income taxes by $.8 million. Since marginal estate tax notes will generally exceed the marginal

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investment expenses. 26 U.S.C. § 212 (formerly § 23(a)(2)(1939 Code)). *See* Ferguson, Freeland and Ascher, *Federal Income Taxation of Estates, Trusts, and Beneficiaries*, Little, Brown and Company 1992, § 4.2.6. Prior to the 1942 legislation, deductions were allowable for both income and estate tax purposes. *Adams v. Commissioner*, 110 F.2d 578 (8th Cir. 1940).

46. Claiming the deduction in computing taxable income reduces the estate's distributable net income. When such expenses are charged to income, the charge reduces fiduciary accounting income which constitutes a ceiling amount of distributable net income. 26 U.S.C. §§ 643(a), 643(b), 652(a), 661(c). Estates and trusts are subject to the maximum marginal rate of federal income tax, presently 39.6%, once taxable income exceeds $7,500. 26 U.S.C. § 1(e). In contrast, individuals (unmarried) are not subject to the maximum marginal rate until taxable income reaches $.25 million.

income tax rates, the government's position reduces the "election" in 26 U.S.C. § 642(g) to a "no choice" decision to always claim administration expenses on the federal estate tax return.

Based on further extension of the government's own theory, where the burden of federal income taxes is borne by a marital or charitable beneficiary, which is increased by shifting a "usable" income tax deduction to a "wasted" estate tax deduction, such charge for increased federal income taxes also reduces the "net value" of the marital and charitable deduction. This results in the same increase to estate taxes, and "tax-on-tax" produced under the Commissioner's position where such expenses are charged to income. In other words, claiming administration expenses as deductions for estate tax purposes which is the lesson to be followed if the Commissioner's argument in this case is followed, will further reduce the marital or charitable deduction regardless of whether income or principal is charged. Amicus submits that while the government has not advanced this argument in this or presumably in any reported case, the conclusion necessarily follows from the circular nature of its reasoning.

Petitioner is asking this Court to effectively repeal 26 U.S.C. § 642(g) by converting an election into a non-election with respect to estates which are intended to be distributed primarily to marital or charitable beneficiaries. Amicus submits that such position lacks backing or support from the legislative history of 26 U.S.C. § 2056(b)(4)(B), the federal estate tax provisions governing marital and charitable deductions in general, or otherwise serves a valid tax policy objective.

Amicus submits that were this Court to adopt the government's position, executors will be forced to claim all administration expenses borne by marital or charitable

beneficiaries against principal and deduct such amounts on the federal estate tax return. In many instances, deducting administration expenses for federal estate tax purposes will have no tax benefit, only tax detriment. Amicus presumes that the Commissioner of Internal Revenue is aware of this result. But, Amicus further submits that the government may not be aware of the Hobson's choice that it seeks to impose on executors of essentially non-taxable estates. If "net value" for purposes of 26 U.S.C. §§ 2056(b)(4)(B) and 2055 always means the gross estate less any and all expenses borne by a marital or charitable beneficiary, regardless of where such expenses are allocated under local law, and regardless of income and appreciation in asset values realized during administration, additional estate taxes will always arise.

The logical extension of the government's position in this case will in many instances produce results which stray beyond the perimeter of fairness and equity. This is because its position has the effect of creating tax where none would otherwise exist.[47]

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47. An estate incurs five tax detriments by being required to deduct administration expenses on to the estate tax return of largely non-taxable estates *e.g.* the entire gross estate passes to a marital deduction trust. First, the federal estate tax deduction has no estate tax benefit since the entire estate passes to a surviving spouse (and/or charity). Second, by foregoing the income tax deduction to avoid an increase in estate taxes, additional income taxes are imposed on the estate. Third, this not only results in income taxes which could have been avoided, but further increases the federal estate tax since the increased taxes are paid by the spouse's share. Fourth, there is also the tax-on-tax effect that results once federal estate taxes are increased. Finally, s tatutory interest is then added to the deficiency for the period beginning with the due date of the return through the date of payment.

CONCLUSION

The judgment of the Eleventh Circuit Court of Appeals in this case should be affirmed.

Respectfully submitted,

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No. 95-1402

IN THE

Supreme Court of the United States

OCTOBER TERM, 1996

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,
v.
ESTATE OF OTIS C. HUBERT, DECEASED,
C&S SOVERAN TRUST COMPANY
(GEORGIA) N.A., A NATIONAL
BANKING ASSOCIATION, CO-EXECUTOR,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF FOR AMICI CURIAE BAPTIST FOUNDATION OF TEXAS AND TERRY L. SIMMONS IN SUPPORT OF RESPONDENT

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Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eleventh Circuit

BRIEF FOR AMICI CURIAE BAPTIST FOUNDATION OF TEXAS AND TERRY L. SIMMONS IN SUPPORT OF RESPONDENT

STATEMENT OF INTEREST OF *AMICI CURIAE*

Amici curiae are Baptist Foundation of Texas (hereinafter referred to as the "Foundation"), represented by Terry L. Simmons as its Senior Vice President and General Counsel, and Terry L. Simmons, individually.

The Foundation was established in 1930 as an incorporated agency of The Baptist General Convention of Texas for the purpose of managing the endowment assets of other Baptist institutions af-

filiated with either The Baptist General Convention of Texas, the Southern Baptist Convention or other state Southern Baptist conventions. The Foundation also provides technical consultation to Baptist institutions and ministries and facilitates charitable gifts made by donors for the benefit of these Baptist causes.

Funds managed by the Foundation are utilized for causes designated by donors. Income earned from investments is distributed according to the specific directions of the donors or, in the absence of specific directions, by action of the Executive Board of The Baptist General Convention of Texas. The Foundation makes no grants.

The Foundation has become a clearinghouse for information related to charitable giving for the agencies it serves so that the Foundation and other charitable agencies can continue to provide the services to society that they have since their inception. The Foundation is committed to the basic Christian principles and sound business practices on which it was established and, within this framework, has set investment and trust guidelines which reflect this commitment.

The Foundation submits that the position advocated by the Petitioner, if validated by the Court, would cause serious harm to charities served by the Foundation because of the reduced gift values and the actual potential reduction in testamentary gifts themselves.

Individually, Terry L. Simmons has practiced law primarily in the exempt organizations area for the past sixteen years. Practicing through both the Foundation and Thompson & Knight, P.C. in Dallas, Texas, he represents charities almost exclusively.

Mr. Simmons has been an advocate for charities nationally, having led or participated in several national efforts to enact legislation increasing or retaining incentives for charitable giving.

Mr. Simmons has served as President of the National Committee on Planned Giving, an organization with 90 local chapters around the country with total membership of over 9,000 attorneys, accountants, trust officers, financial planners, life underwriters and charitable gift planners within charitable institutions. A goal of the National Committee on Planned Giving is to promote a positive atmosphere for gifts to charity, thus encouraging the growth and sustenance of the American system of philanthropy.

Mr. Simmons is a partner, co-editor and co-publisher of *Charitable Gift Planning News*, a monthly newsletter which comments on judicial, legislative and regulatory actions affecting charities. This newsletter is utilized by many of the country's most prestigious law schools and law firms as a resource in the charitable gift planning area.

The organizations represented by Mr. Simmons depend to a large extent on testamentary gifts. Furthermore, philanthropy in general depends on testamentary gifts for a significant portion of the critical resources necessary to carry out charitable activities.

The Foundation and Mr. Simmons respectively submit that the position taken by the Internal Revenue Service and advocated by the Treasury and Justice Departments in this case is mistaken, and that if it is sustained in the United States Supreme Court, will constitute a genuine and significant disincentive to giving by American citizens. Both the Foundation and Mr. Simmons have great respect for the country's system of tax laws and for those who regulate and enforce them. However, recognizing the broad public policy served by the system of incentives which Congress has created to cultivate and grow the philanthropic sector, *amici curiae* feel compelled as leaders in the nonprofit world to present their arguments to the Supreme Court in this case.

SUMMARY OF ARGUMENT

Petitioner's position is illogical within the total framework of the Internal Revenue laws of the United States. In providing for the estate tax charitable deduction as well as the income and gift tax charitable deductions, Congress clearly intended to encourage gifts to charity for public purposes. Consequently, Internal Revenue Code sections which provide for charitable deductions should be liberally construed by the courts to allow the maximum benefit to charity. The position of Petitioner would result in an artificial reduction in the estate tax charitable (and marital) deduction in an arbitrary and artificial manner without diverting the dollars to any alternate purpose, but merely producing additional tax revenue for the federal government. Nowhere in the Internal Revenue Code is there any suggestion of support for the Petitioner's argument. Consequently, Petitioner's argument flies in the face of Congressional intent and should be rejected by the Court.

ARGUMENT

This *amici curiae* brief is filed in support of the position taken by Respondent in this litigation. It is filed with the express permission of Petitioner and Respondent, the letters expressing such consent having been filed with the Clerk of the Court.

Respondent has amply made the case that the payment of post-death estate administration expenses out of post-death income of the estate, paid therefrom by the executor subject to his discretionary authority to do so, does not reduce the marital deduction or charitable deduction for purposes of computing the estate tax due in the estate. This brief is intended to support and amplify the position taken by Respondent with regard to the charitable deduction and is intended to provide additional support and authority for the Court's consideration with regard to the statutory and judicial context within which the deduction for charitable purposes is contemplated.

As Respondent's brief clearly establishes, Petitioner's argument as to the marital deduction provisions of the Internal Revenue Code shows that Petitioner is fundamentally incorrect in its interpretation of 26 U.S.C. § 2056 and its related provisions. The marital deduction provisions enacted by Congress in 1948 contained two net value provisions, including 26 U.S.C. § 2056(b)(4)(A) and 26 U.S.C. § 2056(b)(4)(B). Of relevance in this case is the fact that 26 U.S.C. § 2056(b)(4)(A), which directs that the effect of any estate, succession, legacy or inheritance tax shall be taken into account in determining the allowable marital deduction, has a corresponding provision for the charitable deduction found in 26 U.S.C. § 2055(c). However, it is important to note that there is no corresponding provision regarding the charitable deduction in 26 U.S.C. § 2055 for 26 U.S.C. § 2056(b)(4)(B), which directs that any obligation incurred by a spouse as a result of a gift or any other encumbrance on gifted property be taken into account in determining the value of the gift and the corresponding marital deduction. Therefore, Petitioner's argument, in attempting to apply its reasoning under 26 U.S.C. § 2056(b)(4)(B) to the charitable deduction, is patently and even fatally flawed in that no provision even remotely resembling 26 U.S.C. § 2056(b)(4)(B) appears in the testamentary charitable deduction provisions as set out in 26 U.S.C. § 2055. Clearly, the intentional action of Congress in omitting a parallel provision to 26 U.S.C. § 2056(b)(4)(B) from 26 U.S.C. § 2055 plainly and conclusively evidences the historically strong Congressional intent that testamentary charitable gifts are to be encouraged and that provisions regulating testamentary charitable gifts are to be liberally construed to accomplish the purposes of Congress.

In testimony before Congress in 1973, then Secretary of the Treasury George P. Shultz stated the importance of charitable gifts and their deductibility as follows:

> These organizations ["voluntary charities, which depend heavily on gifts and bequests"]

> are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair.

Bruce R. Hopkins, *The Tax Law of Charitable Giving* § 1.4 at 13 (1993) (quoting "Proposals for Tax Change," Department of the Treasury, April 30, 1973, at 72).

The principle supporting favorable interpretation of Internal Revenue Code sections which provide for deductions to charity is representative of a consistent position of the courts with regard to deduction provisions dating to the earliest days of the tax system, particularly the estate tax system of our country. In the case of *Y.M.C.A. v. Davis*, 264 U.S. 47 (1924), the Court noted that:

> Congress was thus looking at the subject from the standpoint of the testator and not from the immediate point of view of the beneficiaries. It was intending to favor gifts for altruistic objects, not by specific exemption of those gifts but by encouraging testators to make such gifts. Congress was in reality dealing with the testator before his death. It said to him "If you will make such gifts, we'll reduce your death duties and measure them not by your whole estate but by that amount, less what you give."

Id. at 50. Irrespective of the fact that the resolution of specific points of law in this case may not be relevant today, the Court's holding clearly construes an intent by Congress from the genesis of

the estate tax charitable deduction that this deduction be interpreted liberally by the courts.

In *United States v. Provident Trust Company*, 291 U.S. 272 (1934), the Court sought to determine whether an executor would be allowed to recognize the fact that the beneficiary of an estate was incapable of bearing children where the relevant dispositive provision of the will provided for a contingent gift to charity upon the woman's death, should she die without issue. In finding that it was appropriate to allow a deduction for the remainder interest reduced only by the present value of the life interest of the woman, the Court noted:

> We have for consideration simply a statutory provision exempting from a prescribed tax the value of all bequests, etc., made to or for the use of charitable organizations and those which are akin, plainly evidencing a legislative policy to encourage such bequests.

Id. at 285.

The case of *Helvering v. Bliss*, 293 U.S. 144 (1934), presented the question of whether deductions on account of charitable contributions were to be taken from net income as defined by Section 21 of the Revenue Act of 1928 or from ordinary net income as defined by Section 101(c)(7) of the Revenue Act of 1928. It being more advantageous to taxpayers to have deductions taken against net income as defined in Section 21 of the Act, the Court so interpreted the statutory framework of the Revenue Act of 1928. In doing so, the Court stated as follows:

> The exemption of income devoted to charity and the reduction of the rate of tax on capital gains were liberalizations of the law in the taxpayer's favor, were begotten from motives

> of public policy, and are not to be narrowly construed.

Id. at 150-51.

The United States Court of Appeals for the Seventh Circuit recognized the intent of Congress to encourage charitable gifts in its opinion for the case of *Norris v. Commissioner*, 134 F.2d 796 (7th Cir. 1943). Referring to the relevant estate tax charitable provisions of the Revenue Act of 1926, the Seventh Circuit noted that:

> On numerous occasions courts have expressed the opinion that Congress in enacting this legislation sought to encourage gifts to charity, ... by the charitably inclined.

Id. at 798 (citing *Y.M.C.A. v. Davis*, 264 U.S. 47, 50 (1924)). Furthermore, based upon existing case law and Section 303(a)(3) of the Revenue Act of 1926 which provided for the estate tax charitable deduction, the court concluded that:

> Congress intended to reduce the basis of Federal estate tax by such amounts as were given to charity. We believe also that the congressional intent was to prefer charity gifts to estate taxes. It was a case of absolute priority. This legislative intent should not be whittled down by judicial construction. If courts are to respect this legislative expressed intent to encourage gifts to charity, we should not approve of the practice of the Commissioner of resolving doubts in favor of the Government.

Norris, 134 F.2d at 801.

The Seventh Circuit went on to note that even such a clear statement of the intent of Congress should not allow "loopholes" that enable taxpayers to avoid taxes in a way unintended by Congress. *Id.* at 801. In so finding, the court literally defined the difference between cases which justify a result such as that sought by the Petitioner in the case currently before the Court and those which reflect the purpose of the stated intent of Congress. The findings of the Tax Court in *Estate of Street v. Commissioner*, 56 T.C.M. (CCH) 774 (1988), *aff'd in part & rev'd in part*, 974 F.2d 723 (6th Cir. 1992), and the findings of the Tax Court in *Estate of Hubert v. Commissioner*, 101 T.C. 314 (1993), *aff'd*, 63 F.3d 1083 (11th Cir. 1995), with 15 of 17 judges sitting holding for Respondent, by definition cannot be called a loophole. At best, the question presented in this case is a "close call." While *amici curiae* do not accept such a contention, should it be the case, the liberal interpretation compelled by Congress would require the Court to find in favor of Respondent.

The case of *McGlotten v. Connally*, 338 F. Supp. 448 (D.D.C. 1972), involved a suit against a charity by an African American male who had been deprived membership in the charitable organization. The court, which found for the plaintiff on two of three assertions, stated:

> The rationale for allowing the deduction of charitable contributions has historically been that by doing so, the Government relieves itself of the burden of meeting public needs which in the absence of charitable activity would fall on the shoulders of the Government.

Id. at 456. Quoting from a committee report of the House Ways and Means Committee which accompanied the Revenue Act of 1938, the court noted as follows:

> The Government is compensated for its loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from public funds.

Id. at 456 (quoting H.R. Rep. No. 1860, 75th Cong., 3d Sess. 19 (1938)). Obviously, the system of charitable deductions found throughout the Internal Revenue Code is not composed of isolated provisions floating free of any tie to reality. Rather, this system is based upon the firm foundation of Congressional intent and the full recognition of Congress that the allowance of charitable deductions and the utilization of resulting charitable gifts by exempt organizations is a most efficient manner with which to accomplish societal objectives and reduce the parental role of government. That was the case in *McGlotten*, and it remains the case in the matter currently before the Court.

In *Hartwick College v. United States*, 801 F.2d 608 (2d Cir. 1986), the United States Court of Appeals for the Second Circuit considered the issue of whether or not the entire amount of income earned by an estate during the period of administration, which was permanently set aside for charity, was deductible for income tax purposes on Form 1041 which was filed by the estate or whether the deduction was limited to an algebraically determined amount, taking into consideration the taxes to be paid on the income. In discounting the algebraic theory advanced by the government, the court stated:

> We conclude that Congress knew that the algebraic formula for calculations would not be used unless expressly provided for by statute and that by limiting its amendment to § 2055 it did not contemplate that the formula would be applied under other statutes such as § 642(c). Moreover, its limited authorization of the formula is in keeping with the countervailing policy in

> favor of a liberal construction of statutes authorizing deductions for charitable contributions
> ....

Id. at 615.

Finally, in the case of *Flanagan v. United States*, 810 F.2d 930 (10th Cir. 1987), a case extraordinarily similar to the one now before the Court, the decedent executed an instrument denominated as a revocable living trust which was witnessed and notarized as a will and contained testamentary provisions including a charitable bequest. The gift to charity was in the nature of a split-interest transfer, but it did not qualify for the charitable deduction. A dispute arose concerning the validity of the document as a testamentary instrument, and a settlement among the parties resulted in an outright gift to charity which was treated as such on the estate tax return. This arrangement was challenged by the government, arguing that since the gift was a split-interest gift under the will, it must remain so in any agreement between the parties in lieu of litigation.

In holding that the settlement agreement reached by the parties resulted in an outright gift to charity which validated the claimed deduction, the Tenth Circuit noted the position of this Court in *Bob Jones University v. United States*, 461 U.S. 574 (1983), that:

> [w]hile the Supreme Court "has long recognized the primary authority of the IRS and its predecessors in construing the Internal Revenue Code," this authority must still be reviewed with regard to congressional intent.

Flanagan, 810 F.2d at 934 (quoting *Bob Jones University*, 461 U.S. at 596-97 (1983)). Citing *Commissioner v. Estate of Sternberger*, 348 U.S. 187, 190 n.3 (1955), and *Y.M.C.A. v. Davis*,

264 U.S. 47, 50 (1924), the Tenth Circuit also stated: "In enacting the charitable deduction provisions in I.R.C. § 2055 and its predecessors, Congress sought to encourage gifts to charity." *Flanagan*, 810 F.2d at 934. Continuing, the court noted:

> We agree with the Seventh Circuit's formulation in *Norris v. Commissioner*, 134 F.2d 796 (7th Cir.), *cert. denied*, 320 U.S. 756, 64 S. Ct. 63, 88 L. Ed. 450 (1943), that congressional intent to prefer charitable gifts to estate taxes was "a case of absolute priority ...."

Flanagan, 810 F.2d at 934-35 (quoting *Norris*, 134 F.2d at 801 (1943)). The *Flanagan* court then concluded that "we cannot blindly resolve all doubts in favor of the IRS if we are to respect legislative intent to encourage gifts to charity." *Flanagan*, 810 F.2d at 935.

Amici curiae would draw to the Court's attention that the position of Petitioner is contrary to a long and unbroken string of cases, as evidenced by the cases cited within this brief which date back virtually to the very beginning of the estate tax charitable deduction in our country and continue to the present date. The position of Petitioner would result in an artificial reduction in the estate tax charitable (and marital) deduction in an arbitrary and artificial manner without diverting the dollars to any alternate purpose, but merely producing additional tax revenue for the federal government.

While conceding that the paramount role of Petitioner is to zealously seek revenue for the government, this zeal must stop at the gates of a clear statement of Congressional intent spanning many generations. In this case, even more so than in the cases cited above as authority for the premise of liberally interpreting the charitable deduction provisions, the position of Petitioner is untenable. The decedent intended to provide substantial benefits to charity through his will. Clearly, his will made careful provision for that

intention. The final settlement agreement preserves that intention with great clarity. In fact, no party questions the clear intent of the decedent to make a gift to charity. Furthermore, nothing in 26 U.S.C. § 2053 or 26 U.S.C. § 642(g) (the provisions of the Internal Revenue Code which give the executor of an estate the discretion to take administration expenses as a deduction from the estate for estate tax purposes or from the income tax of the estate on Form 1041) constitutes even indirectly a limitation on the general liberal intent of Congress to further philanthropy (as specifically embodied in this instance as to the charitable deduction by 26 U.S.C. § 2055). Rather, Congress has offered implicit but clear guidance to the federal courts to employ a liberal interpretation of the charitable deduction statutes. This is specifically true with regard to the claim asserted by Petitioner in this case which was firmly and correctly rejected by the Eleventh Circuit Court of Appeals.

Respectfully, it is submitted that the position of Petitioner is not logical within the total framework of the Internal Revenue laws of the United States as repeatedly interpreted by its courts over eight decades and that it cannot and should not withstand the scrutiny of this Court.

CONCLUSION

The holdings of the Eleventh Circuit in this case should be affirmed in all respects.

Respectfully submitted,

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Respondent.

On Writ of Certiorari to the
United States Court of Appeals
for the Eleventh Circuit

BRIEF *AMICI CURIAE* OF THE AMERICAN COUNCIL ON EDUCATION AND UNITED WAY OF AMERICA IN SUPPORT OF RESPONDENT

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IN THE

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A NATIONAL BANKING ASSOCIATION, CO-EXECUTOR,
Respondent.

**On Writ of Certiorari to the
United States Court of Appeals
for the Eleventh Circuit**

BRIEF *AMICI CURIAE* OF THE AMERICAN COUNCIL ON EDUCATION AND UNITED WAY OF AMERICA IN SUPPORT OF RESPONDENT

This brief in support of respondent is submitted with the written consent of counsel for respondent and the Solicitor General filed with the Clerk of the Court.

INTEREST OF THE *AMICI CURIAE*

The American Council on Education ("ACE") is a voluntary membership organization comprised of more than 1,800 institutions of higher education from both the

public and private sectors and more than 175 nonprofit educational associations and organizations.

United Way of America is a national service and training center that provides training, resources and support to approximately 1,400 local United Way members. These member United Way organizations raised $3.184 billion in 1995 which supported approximately 45,000 health and human service organizations ranging from disaster relief, emergency food and shelter, job training and crisis intervention to day care, physical rehabilitation and youth development. Apart from government, United Ways support the greatest variety of health and human services in the country.

ACE and United Way of America and their respective members and affiliates are charitable organizations described in Section 501(c)(3) of the Internal Revenue Code. Testamentary charitable contributions constitute a major source of support for ACE. Likewise, testamentary giving contributes to the overall charitable dollars received by United Way of America and its members. Accordingly, any limitation on the charitable deduction is of great concern to these organizations. ACE and United Way of America submit this brief *amici curiae* to assist the Court, first, in appreciating that charitable contributions will be significantly reduced if the decision below is reversed and, second, in ascertaining the proper relationship between state law probate procedures and federal estate taxation.

SUMMARY OF ARGUMENT

In an effort to encourage charitable giving, federal law allows a charitable deduction for the amount of the gross estate which passes to charity. Thus, to the extent that an amount was included in the gross estate reported on the federal estate tax return and actually distributed to the charity, the estate should be allowed a deduction. The

government contends, however, that the charitable deduction must be reduced by estate administration expenses even when those expenses have been properly paid from amounts not included in the gross estate. This position is not supported by the statutory language or by congressional intent. Moreover, in the case of a residuary charitable bequest, the charitable deduction would be reduced not only by the amount of the administration expenses, but also by the additional estate tax generated as a result of the reduced deduction. The resulting "multiplier" effect will have a severe adverse impact on charitable bequests.

In its brief, the government contends that the amount of the charitable deduction should not depend on how the executor has allocated administration expenses or on the particular state law governing such allocations. Rather, the government seeks to impose a uniform federal rule requiring a reduction in the charitable deduction for all administration expenses, regardless of the source of their payment. The government's approach misconstrues the proper relationship between the federal law imposing the estate tax and state law which defines the interests upon which the estate tax acts. The amount of the residuary estate which a charity will actually receive is a matter for factual determination based on state law and proper probate procedures, not on fiction or an absolute and arbitrary federal rule. In addition, the maritai deduction regulation upon which the government heavily relies does not in fact require a reduction in the marital or charitable deduction as the government asserts. Rather, the relevant regulations, as well as a venerable revenue ruling issued by the Internal Revenue Service, support the conclusion that a proper allocation of administration expenses to estate income should not necessitate a reduction or diminution of the charitable or marital deduction, provided that the allocation is made solely in a fiduciary capacity in accordance with the general standards of trust administration prescribed by applicable state law.

ARGUMENT

I. THE GOVERNMENT'S POSITION WOULD DEPRIVE ESTATES AND THEIR CHARITABLE BENEFICIARIES OF THE FULL BENEFIT OF THE FEDERAL ESTATE TAX DEDUCTION FOR AMOUNTS DISTRIBUTED TO CHARITY

A. Reducing The Charitable Deduction By Administration Expenses Properly Charged To Income Would Undermine Congressional Intent

Congress intentionally accorded charitable bequests special estate tax benefits under the Internal Revenue Code (the "Code"). Specifically, Section 2055(a) of the Code allows a deduction "from the value of the gross estate" for the amount of "all bequests, legacies, devises, or transfers" to charity. I.R.C. § 2055(a). A decedent's gross estate consists of the value on the date of death (or on the alternate valuation date) of all of a decedent's property. I.R.C. § 2031(a). Only property included in the decedent's gross estate may qualify for the charitable deduction. I.R.C. § 2055(d); 26 C.F.R. § 20.2055-1(a) (1995). Income received by the estate during its administration is not included in the gross estate. Thus, even if estate income is properly paid to the charitable beneficiary under state law, no additional estate tax deduction is allowed. By the same token, to the extent that administration expenses are properly paid from post-mortem income under state law, the amount of the gross estate actually passing to the charitable beneficiary is not reduced.

Nevertheless, through a series of strained arguments at odds with the realities of estate administration, the government contends that, where estate administration expenses are properly paid from estate income, the estate and charitable beneficiary should not receive the benefit of the full charitable deduction for the amount of the gross estate actually passing to the charity. As the courts below held, however, just as the estate should not receive

a charitable deduction for more of the gross estate than actually passes to charity,[1] so should it not receive a lesser deduction. To hold otherwise would contravene the language of the statute which directs that there be deducted "from the value of the gross estate the amount of all bequests, legacies, devises, or transfers" to charity. I.R.C. § 2055(a).

Moreover, such an unwarranted reduction in the amount passing to charity is in direct conflict with Congress's express intent to foster charitable giving. As this Court itself has recognized, in enacting the charitable deduction provisions in Section 2055 and its predecessors, Congress sought to encourage gifts to charity. *Commissioner v. Estate of Sternberger*, 348 U.S. 187, 190 n.3 (1955); *YMCA v. Davis*, 264 U.S. 47, 50 (1924). Indeed, it is now well settled that the "congressional intent to prefer charitable gifts to estate taxes was 'a case of absolute priority . . . [and that] [While] loopholes should not be permitted to diminish estate tax payments by ostensibly charitable bequests which may never become effective,' [the courts] cannot blindly resolve all doubts in favor of the IRS if [they] are to respect legislative intent to encourage gifts to charity." *Flanagan v. United States*, 810 F.2d 930, 934-35 (10th Cir. 1987) (quoting *Norris v. Commissioner*, 134 F.2d 796, 801 (7th Cir.), *cert. denied*, 320 U.S. 756 (1943)). As illustrated by the examples discussed below, the government's position in this case would frustrate Congress's intent to encourage charitable bequests.

B. The Government's Position Would Severely And Adversely Impact Charitable Beneficiaries

The government's position would require that the amount of the charitable deduction be reduced by the

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[1] *See also Harrison v. Northern Trust Co.*, 317 U.S. 476, 480 (1943) (estate is entitled to deduct only the amount actually passing to the charitable beneficiary).

amount of the estate's administration expenses even when such expenses were properly charged to post-mortem income not includible in the gross estate. The two short examples which follow illustrate the harsh effects of the government's position on charitable beneficiaries.

Assume, for example, that a decedent had a gross estate of $10,000,000. His will bequeathed $600,000 (the amount protected from federal estate tax by reason of the unified credit allowed by Section 2010) to his family and left his residuary estate to charity. The will directed that all taxes, debts and administration expenses be paid from the residuary estate. Assume further that the estate incurred $500,000 of administration expenses, $200,000 of which were properly paid from estate income and deducted on the estate's fiduciary income tax return,[2] and $300,000 of which were paid from estate corpus and deducted on the federal estate tax return. Based on the foregoing facts, the amount of the *gross estate* actually passing to charity is $9,100,000 ($10 million reduced by the $600,000 bequest and expenses of $300,000 paid from the corpus included in the gross estate).[3] The federal estate tax imposed on the estate will therefore be zero. If, however, as the government contends, the charitable deduction must also be reduced by the expenses properly paid from estate income, the charitable deduction will be reduced not only by the additional $200,000 of administration expenses, but also by the estate tax generated as

[2] Section 2053 of the Code allows estate administration expenses to be deducted from the gross estate. Section 642(g), however, authorizes executors to elect to deduct such expenses on the estate's fiduciary income tax returns or on the estate tax return.

[3] As the government noted in its brief (Petitioner's Brief at 19), it is not disputed that, to the extent that administration expenses are paid directly from the corpus of the residuary estate passing to charity, the charitable deduction must be commensurately reduced.

a result of the lower deduction.[4] As a consequence, even though the charity should actually have received an amount of the gross estate equal to $9,100,000, a charitable deduction of only $8,777,049 will be allowed. As a result, the estate's estate tax liability will increase from zero to $122,951 or 61.47% of the $200,000 of administration expenses paid from income. This $122,951 will pass to the government, rather than to the charity.

The severity of the impact on the charitable beneficiary is even more starkly illustrated in the case of a larger taxable estate. Assume, for example, that all of the above facts remain the same except that the decedent's will leaves $3,000,000 to his family, rather than only $600,000.[5] If the estate is allowed a charitable deduction for the actual amount of the gross estate passing to the charity, the federal estate tax liability will be $2,439,999. If, however, the charitable deduction is reduced for the administration expenses properly paid from estate income, the estate's tax liability will increase by $244,445 or 122%

[4] Any reduction in the charitable deduction will increase the amount of estate tax owed, which will further decrease the charitable deduction, which will increase the amount of estate tax owed, and so on. The resulting interrelated computation or "multiplier" effect will cause the amount of additional estate tax owed as a result of the initial reduction in the charitable deduction to far exceed the amount which would be owed if the estate's marginal estate tax rate were simply applied to the amount of the reduction.

[5] In larger estates, it is not uncommon for a decedent to provide for his family through lifetime gifts or pre-residuary bequests and then to leave his residuary estate to charity. Alternatively, he may divide his residuary estate between his family and charity or utilize residuary split-interest trusts. In all of these situations, the issue presented by this case is potentially determinative of the amount which the charitable beneficiary will receive. Because estates utilizing this type of planning are typically large, residuary charitable bequests represent a significant source of funds for charitable organizations. Thus, although not all charitable bequests are affected by the issue presented here, its significance for the charitable community should not be underestimated.

of the $200,000 of administration expenses paid from income. Thus, as a result of the disallowed deduction for $200,000 of the gross estate which would actually have been distributed to the charity, the charity will receive $244,445 less. This harsh impact was not intended by Congress.

II. THE GOVERNMENT'S EFFORT TO IMPOSE AN ABSOLUTE FEDERAL RULE IGNORES THE PROPER ROLE OF STATE LAW AND IS NOT SUPPORTED BY THE INTERNAL REVENUE SERVICE'S OWN REGULATIONS

In its brief, the government contends that the amount of the charitable deduction should not turn on how the executor has allocated the administration expenses or on how state law permits such expenses to be allocated. Rather, the government describes the proper treatment of the allowable administration expenses for estate tax deduction purposes as a "federal question." Petitioner's Brief at 32. Although the interpretation and implementation of the federal estate tax is certainly a federal matter, the government's position would go too far in imposing a federal rule regarding the payment of administration expenses which is at odds with the realities of the administration of decedents' estates, as well as with the Internal Revenue Service's own regulations and revenue rulings.

This Court in *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940), explained the interrelationship between state law and the federal estate tax law as follows:

> State law creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed.

Id. at 80. Accordingly, numerous courts have recognized that the proper devolution of property in the estate, the composition of the residuary estate and the identification of the property from which debts, taxes and administration expenses must be paid are all matters to be determined

by state law. *Riggs v. Del Drago*, 317 U.S. 95 (1942).[6] Thus, the federal estate tax acts on the estate after the property rights of the beneficiaries have first been determined in accordance with state law. The federal estate tax thereby accords with and reflects the reality of the estate distribution, rather than creating a fictional distribution intended to generate additional tax revenues.

State property law impacts the imposition of the federal estate tax in many ways. For example, how estate taxes are apportioned among the beneficiaries, and thus whether the marital or charitable deduction will be reduced by such taxes, is clearly a matter determined by state law. *Riggs v. Del Drago*, 317 U.S. at 100-01; *Harrison v. Northern Trust Co.*, 317 U.S. 476. As noted by this Court in *Harrison v. Northern Trust Co.*, 317 U.S. at 479, "the ultimate thrust of the federal estate tax is to be determined by state law."

Similarly, although federal law is determinative of the tax imposed on property subject to a general power of appointment, it is state law that determines to whom property can be appointed and thus whether a power is a general power within the meaning of the federal statute. *Morgan v. Commissioner*, 304 U.S. 78. As this Court has recognized, it is entirely proper that state law control "in determining the nature of the legal interest which the taxpayer had in the property or income sought to be reached by the statute." *Id.* at 82.

It is equally well established that whether an estate expenditure is chargeable to principal or to income is a matter of state law. *Estate of Richardson v. Commis-*

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[6] *See also Harris v. United States*, 370 F.2d 887, 893 (4th Cir. 1966); *Estate of Warren v. Commissioner*, 93 T.C. 694 (1989), *rev'd on other grounds and remanded*, 981 F.2d 776 (5th Cir. 1993); *Estate of Horne v. Commissioner*, 91 T.C. 100 (1988); *Estate of Fine v. Commissioner*, 90 T.C. 1068 (1988), *aff'd mem.*, 885 F.2d 879 (11th Cir. 1989); *Estate of Reid v. Commissioner*, 90 T.C. 304 (1988); *Estate of Short v. Commissioner*, 68 T.C. 184, 190 (1977), *acq.*, 1977-2 C.B. 2.

sioner, 89 T.C. 1193 (1987); *Estate of Street v. Commissioner*, 56 T.C.M. (CCH) 774 (1988), *aff'd in part and rev'd in part*, 974 F.2d 723 (6th Cir. 1992). Thus, whether such an expenditure will in fact reduce the amount of the gross estate passing to a charitable beneficiary will properly depend on state law.

The government attempts to override these settled principles in several ways. First, the government asserts that administration expenses must reduce the marital or charitable deduction in all cases, regardless of whether they are paid from principal or income, because they reduce the "real value" or the "net economic interest" received by the surviving spouse or charity. Petitioner's Brief at 27. In seeking to support its position, the government maintains that "[t]he 'value' of property left as a bequest includes, as one of the sticks in the bundle of rights, the right to receive the stream of income derived from that property." *Id.* at 27. Such a contention ignores the fact that the nature of the "bundle of rights" and of its component "sticks" is determined by state law, not federal law. Indeed, state law varies considerably regarding the rights which various beneficiaries have to share in the post-mortem income of an estate.[7]

[7] Virtually all states provide that income earned on property which is specifically bequeathed shall be paid to the beneficiary of such property. Beyond this, however, state law varies considerably. In some states, a proportionate share of the post-death income is paid to the legatee of a pecuniary bequest, but only if the bequest is in trust. *See, e.g.*, Alaska Stat. § 13.38.040(b)(2) (1995); Ariz. Rev. Stat. Ann. § 14-7405(B)(2) (1995); N.Y. Est. Powers & Trusts § 11-2.1(d)(2)(B) (McKinney Supp. 1996). In others, an outright pecuniary bequest will share, but only if the spouse is the beneficiary. *See, e.g.*, 760 I.L.C.S. ch. 15, para. 6(b)(2) (Smith-Hurd 1992); Md. Code Ann., Est. & Trusts § 7-304(b)(2) (1991). In still other states, pecuniary bequests do not share in income regardless of whether they are outright or in trust. *See, e.g.*, Cal. Prob. Code § 12003 (West 1991); Del. Code Ann. tit. 12, § 6105(b)(2) (1995 repl.); N.J. Stat. Ann. § 3B:19A-12(a)(2) (West Supp. 1996). And, finally, in some states, all beneficiaries share proportionately in the post-death income. *See, e.g.*, Tex. [Continued]

Second, the government argues that administration expenses accrue at the date of death, even though the amount of such expenses is not then ascertainable. According to the government, administration expenses are therefore an encumbrance existing as of the moment of death which must reduce the gross estate. Petitioner's Brief at 24. *See also Burke v. United States*, 994 F.2d 1576 (Fed. Cir.), *cert. denied*, 510 U.S. 990 (1993). The government's contention, however, is divorced from the realities of estate administration. Clearly, the amount of the administration expenses and, equally importantly, their nature, can be determined only as the estate administration proceeds and the expenses are in fact incurred.

Finally, for purposes of determining the amount of either a charitable or marital deduction, the government places major reliance on a marital deduction regulation which provides that "[i]n determining the value of the interest in property passing to the spouse account must be taken of the effect of any material limitations upon her right to income from the property." 26 C.F.R. § 20.2056

[7] [Continued]
Prob. Code Ann. § 378B(d) (West Supp. 1996). In addition, many states provide that interest will be paid on pecuniary bequests if they are not paid within a certain period of time after the date of death. *See, e.g.*, Ga. Code Ann. § 53-2-97 (1995); Cal. Prob. Code § 12003 (West 1991); Tex. Prob. Code Ann. § 378B(f) (West Supp. 1996). Again, the time period and rate of interest vary from state to state. For instance, in some states, interest begins to accrue on pecuniary bequests one year after the testator's death. *See, e.g.*, Cal. Prob. Code § 12003 (West 1991); Ga. Code Ann. § 53-2-97 (Michie 1982). In others, interest begins to run one year after the date the personal representative is appointed. *See, e.g.*, Tex. Prob. Code Ann. § 378B(f) (West Supp. 1966). In some states, the rate of interest is based on a formula. *See, e.g.*, Cal. Prob. Code § 12001 (West Supp. 1996) (rate is three percentage points less than the legal rate on judgments in effect one year after the date of the testator's death), while in others, the percentage rate is set by statute. *See, e.g.*, Ga. Code Ann. § 7-4-2 (1989) (applicable rate of interest is seven percent); Tex. Prob. Code Ann. § 378B(f) (West Supp. 1996) (applicable rate of interest is six percent).

(b)-4(a) (1995). The regulation illustrates this general principle with the following example:

> An example of a case in which this rule may be applied is a bequest of property in trust for the benefit of the decedent's spouse but the income from the property from the date of the decedent's death until distribution of the property to the trustee is to be used to pay expenses incurred in the administration of the estate.

Id. According to the government, this regulation "specifies that the marital deduction *must* be reduced whenever administration expenses have been paid from post-death income, regardless of the exact amount of the expenses in relation to the income." Petitioner's Brief at 31 (emphasis supplied); *see also id.* at 30 n.8. In fact, the Internal Revenue Service's regulations and rulings do not say what the government claims they say and, thus, do not support the absolute rule for which the government contends.

In the first place, the example quoted above does not state, as the government repeatedly asserts, that the rule requiring adjustments for material limitations "*must*" apply if marital income is used to pay administration expenses; rather, the regulation cites payment of administration expenses from marital income as an example of a case in which the rule "*may*" be applicable. Whether the rule applies in a particular case depends on whether, under the general principle of the regulation, the payment of such expenses from income falls within the category of "material limitations" on the right to receive income from the property.

In this regard, the government ignores the fact that the marital deduction statute explicitly states that, for purposes of determining the value of the interest passing to the surviving spouse,

> where such interest or property is encumbered in any manner, or where the surviving spouse incurs any obligation imposed by the decedent with respect to

> the passing of such interest, such encumbrance or obligation shall be taken into account *in the same manner as if the amount of a gift to such spouse of such interest were being determined.*

I.R.C. § 2056(b)(4)(B) (emphasis supplied). This direction to look to the gift tax regulations is repeated in the very same marital deduction regulation upon which the government relies in its brief.[8]

The relevant gift tax regulations address a spouse's right to income from a marital trust. The regulations state the general rule that a trust will qualify for the marital deduction "if the effect of the trust is to give [the spouse] substantially that degree of beneficial enjoyment of the trust property during [the spouse's] life which the principles of the law of trust accord to a person who is unqualifiedly designated as the life beneficiary of a trust." 26 C.F.R. § 25.2523(e)-1(f)(1) (1995). Thus, for purposes of determining the nature of the property interests to which the estate or gift tax will apply, the regulations again look to state law trust principles. In addition, the regulations specifically provide that "[a]mong the powers which if subject to reasonable limitations will not disqualify the interest transferred in trust are the power to determine the allocation or apportionment of receipts and disbursements between income and corpus. . . ." 26 C.F.R. § 25.2523(e)-1(f)(4) (1995). The regulations thus explicitly reject any hard-and-fast rule regarding allocation of receipts and disbursements in favor of a case-by-case determination that is dependent upon whether the powers granted are subject to "reasonable limitations."[9]

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[8] "The marital deduction may be taken only with respect to the net value of any deductible interest which passed from the decedent to his surviving spouse, *the same principles being applicable as if the amount of a gift to the spouse were being determined.*" 26 C.F.R. § 20.2056(b)-4(a) (1995) (emphasis supplied).

[9] The regulations provide that:

> In the case of a trust, the rules to be applied by the trustee in allocation of receipts and expenses between income and corpus

How then can the totality of the statutory language and the regulations be reconciled with the government's absolute position that administration expenses paid from income *must* in all cases reduce the marital and/or charitable deduction? In the view of the *amici curiae*, it cannot. Rather, we believe that the approach adopted by the Internal Revenue Service more than a quarter-century ago in Revenue Ruling 69-56, 1969-1 C.B. 224, represents the correct approach in resolving this issue.

In Revenue Ruling 69-56, the Internal Revenue Service provided examples of fiduciary powers that do not constitute "material limitations" on a spouse's right to receive income from a marital trust.[10] In the first example, the

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must be considered in relation to the nature and expected productivity of the assets transferred in trust, the nature and frequency of occurrence of the expected receipts, and any provisions as to change in the form of investments. If it is evident from the nature of the trust assets and the rules provided for management of the trust that the allocation to income of such receipts as rents, ordinary cash dividends and interest will give to the spouse the substantial enjoyment during life required by the statute, provisions that such receipts as stock dividends and proceeds from the conversion of trust assets shall be treated as corpus will not disqualify the interest transferred in trust. Similarly, provision for a depletion charge against income in the case of trust assets which are subject to depletion will not disqualify the interest transferred in trust, unless the effect is to deprive the spouse of the requisite beneficial enjoyment. The same principle is applicable in the case of depreciation, *trustees' commissions, and other charges.*

26 C.F.R. § 25.2523(e)-1(f)(3) (1995) (emphasis supplied).

[10] In its brief, the government in a footnote attempts to dismiss Revenue Ruling 69-56, stating that the ruling "expressly addressed only whether 'the *inclusion of such powers* or directions *in the governing instrument* * * * [would] result in the disallowance or diminution of the marital deduction.' . . . It did not, as the Tax Court implied, address whether the actual payment of such administration expenses out of corpus or income of the marital bequest would require a reduction in the marital deduction." Petitioner's Brief at 30 n.8. This facile distinction ignores the ruling's true

governing instrument confers upon the fiduciary a power "[t]o charge to income or principal, executor's or trustee's commissions, legal and accounting fees, custodian fees, and similar administration expenses." Rev. Rul. 69-56, 1969-1 C.B. 224 (Ex. 1). In the second example, the governing instrument confers upon the fiduciary a general power to determine the manner in which receipts and expenses will be allocated between income and principal. The example stipulates further that "[u]nder applicable State law the fiduciary's determination must be made so as to balance fairly the interests of [the income beneficiary and the remainderman]." *Id.* The ruling concludes that "the grant of such power in and of itself does not evidence the intention to deprive the surviving spouse of the beneficial enjoyment required by the statute, and does not result in the disallowance or diminution of the marital deduction." *Id.* at 225. In reaching this conclusion, the Service relies upon the fact that

> applicable State law requires that the fiduciary's determination must be made so as to balance fairly the interests of the income beneficiary and the remainderman. . . . [T]he applicable State law illustrates the general limitation imposed by the law of trusts upon the exercise of such a power, namely, that all exercises of discretion by the fiduciary are to be made solely in a fiduciary capacity in accordance with the general standards of trust administration imposed upon fiduciaries.

Id. at 224. Thus, rather than adopting an absolute rule such as that advocated by the government now, the ruling recognizes that the allocation of expenses to income or

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relevance and meaning. The real concern addressed by the ruling and the regulations is not just that particular fiduciary powers may be included in the governing instrument, but that they would be exercised. The clear import of the ruling is that, so long as they are properly exercised in conformity with applicable state law principles governing fiduciary discretion, they will not cause a disallowance or diminution of the marital deduction.

principal *may*, but will not necessarily, constitute a material limitation which must be taken into account in determining the amount of the marital (or charitable) deduction. In order to make this determination, a court must assess the facts of the particular case in the context of the applicable state trust law and the constraints which such law places upon fiduciaries.[11]

In the instant case, Georgia law authorized the allocation of estate administration expenses to income rather than principal, if permitted under the will. The decedent's will granted his executors the power to "charge any expenses against income or principal or apportion the same" and directed the executors to "make any election permitted by any tax law . . . if in the opinion of my Executors . . . such election is for the combined best interest of my Estate and the beneficiaries." From 1986 to 1990, the estate generated over $5,000,000 of income and incurred over $1,400,000 in administration expenses. In a proper exercise of fiduciary discretion, the executors allocated $506,989 of those expenses to principal and the remainder to income. There is no suggestion that this allocation was anything other than a proper exercise of fiduciary discretion which accorded with the general standards imposed upon fiduciaries by state law.

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[11] In a very recent case, *Estate of Sobota v. Commissioner*, 71 T.C.M. (CCH) 3217 (1996) (Tannenwald, J.), the Tax Court applied precisely this analysis. Because under the applicable state law (Wisconsin) the personal representative's fee was required to be charged to principal passing to the decedent's wife, the Tax Court held that the marital deduction must be reduced.

CONCLUSION

Accordingly, the judgment of the United States Court of Appeals for the Eleventh Circuit should be affirmed.

Respectfully submitted,

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